REGULATION IMPACT STATEMENT

UNFAIR TERMS IN INSURANCE CONTRACTS

NOVEMBER 2012

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1. BACKGROUND

UNFAIR CONTRACT TERMS LAWS

Australian Consumer Law and the *Australian Securities and Investments Commission Act 2001*

The Productivity Commission, in its 2008 *Review of Australia's Consumer Policy Framework*, recommended that a new generic, national consumer law should apply in all sectors of the economy. It further recommended that this generic law include national unfair contract terms (UCT) laws. The Productivity Commission broadly defined 'unfair contract terms' as terms '*that disadvantage consumers, but ... are not reasonably necessary for the protection of the legitimate interests of suppliers*'.[1]

The Productivity Commission's recommendations have been implemented through the Australian Consumer Law (ACL) and related reforms. The final form of the UCT laws in the ACL draws on the previous Victorian UCT laws, the Productivity Commission's recommendation and the experience of the enforcement of UCT laws in Victoria and the United Kingdom.

The UCT laws were implemented as laws of the Commonwealth and of Victoria and New South Wales on 1 July 2010 and then extended to apply in all other States and Territories on 1 January 2011. The UCT laws are expressed to apply to all sectors of the economy, and to all businesses operating in those sectors in Australia which use standard form contracts in their dealings with consumers. The UCT laws apply to most financial products and financial services through the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

Subdivision BA of the ASIC Act (included at Appendix A) outlines how UCT laws currently apply to most financial products and financial services. In short, UCT laws:

- apply to a 'consumer contract' (a contract relating to an acquisition predominantly for personal, domestic or household use or consumption) that is a 'standard form' contract (typically, a contract determined by one party with unequal bargaining power in the absence of negotiation and discussion);[2] and

- do not apply to a term in such contracts that defines the 'main subject matter', sets the upfront price payable under the contract, or is a term that is required or permitted by law.

The effect of the legislation is to make void a term in such a contract that is 'unfair' which is if:[3]

- it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and

- it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and

- it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

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1 Productivity Commission Inquiry Report, Volume 2 – Chapters and Appendixes, p 403, 30 April 2008, http://www.pc.gov.au/__data/assets/pdf_file/0008/79172/consumer2.pdf

2 Subdivision BA of the ASIC Act defines the terms 'consumer contract' and 'standard form contract'.

3 Section 12BG sets out the meaning of 'unfair' and the matters a court may take into account in determining whether a term is unfair, and section 12BH provides examples of unfair terms.

In determining whether a term is unfair, a court may take into account such matters as it thinks relevant, but must take into account the extent to which the term is transparent (that is, expressed in reasonably plain language, legible, presented clearly, and readily available to any party affected by the term), and the contract as a whole. If a court finds that a term is unfair, the term is void (that is, the term is treated as if it never existed) and the contract will continue to bind parties if it is capable of operating without the unfair term.[4]

Since the introduction of the UCT laws, Australia's consumer agencies have worked to inform businesses about their obligations under the ACL and have worked with them to improve terms and conditions in standard form consumer contracts. For example, the ACCC has recently conducted reviews of standard form contracts in the telecommunications and vehicle rental industries and have engaged with key traders to facilitate amendments to terms which may be potentially unfair. On 1 July 2010, a national guide to the UCT laws was issued by all Commonwealth, State and Territory consumer agencies, and a revised edition was published on 20 January 2011.[5]

Exclusion for insurance contracts

While the UCT laws apply to most financial products and services, they do not apply to standard form contracts covered by the *Insurance Contracts Act 1984* (IC Act). This exclusion reflects that the operation of the UCT laws in the ASIC Act is affected by section 15 of the IC Act, which provides that:

> (1) A contract of insurance is not capable of being made the subject of relief under:
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> (a) any other Act; or
>
> (b) a State Act; or
>
> (c) an Act or Ordinance of a Territory.
>
> (2) Relief to which subsection (1) applies means relief in the form of:
>
> (a) the judicial review of a contract on the ground that it is harsh, oppressive, unconscionable, unjust, unfair or inequitable; or
>
> (b) relief for insured from the consequences in law of making a misrepresentation;
>
> but does not include relief in the form of compensatory damages.

History

An exclusion for insurance contracts from State and Territory laws regarding judicial review laws was recommended by the Australian Law Reform Commission (ALRC) in its 1982 report on insurance contracts. The reasons cited by the ALRC were:

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[4] *Australian consumer law – unfair contract terms*, http://www.asic.gov.au/asic/asic.nsf/byHeadline/Unfair-contract-terms-law?opendocument

[5] *A guide to the unfair contract terms law,* developed by the Australian Capital Territory Office of Regulatory Services, Australian Competition and Consumer Commission, ASIC, Consumer Affairs and Fair Trading Tasmania, Consumer Affairs Victoria, New South Wales Fair Trading, Northern Territory Consumer Affairs, Office of Consumer and Business Affairs South Australia , Queensland Office of Fair Trading and Western Australia Department of Commerce, Consumer Protection, http://www.accc.gov.au/content/index.phtml/itemId/937060

- to avoid difficulties of distinguishing between business and non-business contracts in the insurance context;

- to avoid insurance contracts being subject to judicial review in some jurisdictions and not others; and

- the doctrine of 'utmost good faith', especially when elevated to a contractual term, '*should provide sufficient inducement to insurers and their advisers to be careful in drafting their policies and to act fairly in relying on their strict terms*.'

The version of section 15 that was included in the IC Act went beyond the ALRC recommendation, and excluded relief under Commonwealth law (as well as State and Territory laws) regarding "*harsh, oppressive, unconscionable, unjust, unfair or inequitable contracts*". The relief that was excluded encompassed, but was not limited to, "*relief by way of variation, avoidance or termination of a contract*".

A 1992 report on consumer credit insurance by a Government Working Party noted that there was a great deal of confusion about the scope of the 1984 version of section 15. In response, the section was amended in 1994 through the *Insurance Laws Amendment Act (No 2) 1994*, to reflect the wording outlined above. In its Consumer Credit Insurance Review of July 1998, the Australian Competition and Consumer Commission (ACCC) noted that the 1994 changes to section 15, among other things, "*clarified the position of making a claim under other legislation for compensatory damages*" so that consumers should be more willing to exercise their rights.

Recent reconsideration of insurance exclusion

The issue of unfair terms in insurance contracts and, in particular, whether section 15 of the IC Act needed to be retained, was considered as part of the second stage of the review of the IC Act in 2004. Submissions to that review were '*starkly divided on the ongoing need for section 15 with strongly held views being expressed both in favour and against its retention*'.

The Review Panel concluded that the consequences of repealing section 15 were too uncertain to warrant taking that step. However, the arguments were finely balanced, and if a nationally consistent model for review of consumer unfair contracts were developed, the balance of consideration may shift and the issue should be revisited.

The Productivity Commission, in its 2008 *Review of Australia's Consumer Policy Framework*, extensively considered the benefits and costs of a new generic consumer law including provisions to safeguard against UCT more broadly. Drawing on evidence largely drawn from the Victorian and UK experiences with UCT provisions, the Productivity Commission concluded that:

- There are sound in-principle rationales for proscribing UCT that cause consumer detriment, in particular to reflect that consumers often do not read (what are often complex and long) contracts and may mistakenly ignore the risks that some suppliers will use particular terms against them. This can result in inefficient risk bearing by firms and consumers.

- 'Unfair' terms appear to be widespread in contracts. While there is only limited evidence concerning the extent of their exploitation and the accompanying detriment for consumers, some emerging information suggests the detriment is likely to be non-trivial.

- There would also be some costs from a law against unfair terms, including administrative and compliance costs. However, there is little evidence of any significant business compliance costs in Victoria or in the many countries that have enacted laws against UCT.

As noted above, the Productivity Commission recommended that a provision should be incorporated in the new national generic consumer law that addresses UCT. However, the Productivity Commission took a whole-of-economy approach to considering UCT laws, with no specific consideration given to UCT laws in the insurance context.

In a 2009 inquiry by the Senate Economics Legislation Committee (the Committee) into the *Trade Practices Amendment (Australian Consumer Law) Bill 2009* (the Bill containing legislation to introduce the ACL, including the UCT laws recommended by the Productivity Commission), one issue that was considered was that section 15 of the IC Act would operate to prevent some or all of the UCT provisions proposed to be inserted in the ASIC Act (which mirror those in the ACL in respect of financial services) applying to terms in insurance contracts.

Views differed on whether the inclusion of insurance contracts under the UCT provisions of the ASIC Act was appropriate. Submissions from consumer representatives argued that the UCT provisions should apply to insurance contracts. Submissions from insurance industry representatives argued that there was no justification to have the UCT provisions apply to insurance contracts.

Following consideration of claims made by stakeholders (much of which is repeated in the 'Problem' section of this RIS) and the findings of the 2004 Review of the IC Act and the Productivity Commission's *Review of Australia's Consumer Policy Framework*, the Committee stated in its report that:

- The Committee is of the view that consumers are not provided with adequate protection in insurance contracts under existing law.

- The Committee recommends that the Government address insurance contract legislation to ensure that the IC Act provides an equivalent level of protection for consumers to that provided by the ACL.

- Consideration by the Government of the 2004 review of the IC Act should determine whether this will be achieved by amending the IC Act to achieve a harmonisation with the amendments proposed in the ACL, or by amending the ACL to apply to insurance contracts.

In March 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, introduced the *Insurance Contracts Amendment Bill 2010* (ICA Bill) into the Parliament. The ICA Bill did not pass the Senate before the calling of the federal election in July 2010, and the Bill lapsed.

The Bill did not explicitly address UCT. At the same time as the ICA Bill was introduced into Parliament, Minister Bowen released a paper seeking comments on options to address unfair terms in insurance contracts. In the latter part of 2010, the current Assistant Treasurer, the Hon David Bradbury MP, discussed the issue of UCT and insurance at various meetings with stakeholders. In March 2011, Minister Bradbury convened a roundtable discussion of key stakeholders at which various options were discussed.

On 12 December 2011, Treasury released a draft regulation impact statement (RIS) for public consultation on options for extending UCT laws to insurance contracts. Following further consideration and an assessment of stakeholder submissions on the 2011 draft RIS, this RIS analyses options for applying UCT laws to insurance contracts.

The Productivity Commission released a draft report in April 2012 into *Barriers to Effective Climate Change Adaptation*. While unfair contract terms was not the specific focus of the report, the Productivity Commission noted that changes to insurance regulations including the 'key fact sheet', standard definition of 'flood', the proposed application of unfair contract terms legislation to general

insurance, and reforms to financial advice regulations 'could improve outcomes for consumers with generally modest costs for insurers.'

EXISTING CONSUMER PROTECTION FOR INSURANCE CONTRACTS

There are multiple existing rules offering protection to policyholders from being negatively impacted by policy terms in certain circumstances. The rules can be categorised into three groups:

- *Pre-contractual disclosure:* rules for informing policyholders about the terms of the policy before it is entered into;
- *Utmost good faith:* rules preventing parties from relying on terms if to do so would be inconsistent with the doctrine of 'utmost good faith'; and
- *Rules on reliance on specific terms*: rules directed at preventing reliance by insurers on specific types of policy terms in certain circumstances.

Pre-contractual disclosure

One of the most common situations in which dissatisfaction and perceived unfairness arises in the context of insurance contracts is when an insurer seeks to deny a claim based on an exclusion or limitation on cover that the insured argues was not, until the time of the claim, fully known or understood by the insured.

The issue of protecting insureds from unusual and unexpected limitations on cover was examined by the ALRC in its 1982 report on insurance contracts. This led to the enactment of the 'standard cover' and 'unusual terms' provisions in the IC Act (discussed further below). The legislative history of those provisions, particularly those relating to standard cover, is described in the judgement of Einstein J of the NSW Supreme Court in the decision of *Hams & Ors v CGU Insurance Limited* [2002] NSWSC 273 (Hams) from paragraph 208.

The key current laws governing pre-contractual disclosure for insurance are:

- the 'standard cover' rules in section 35 for certain types of prescribed household/personal contracts;
- the 'unusual terms' rules for other contracts in section 37; and
- Product Disclosure Statement (PDS) rules for retail customers (under the *Corporations Act 2001*).[6]

Section 35 IC Act – standard cover

Section 35 of the IC Act provides that standard cover (that is, minimum levels of cover for prescribed events) will be deemed to be included in certain classes of prescribed insurance policy, including home buildings insurance and home contents insurance (other than cover notes and renewals). The standard cover terms and conditions are set out in the *Insurance Contracts Regulations 1985* (IC Regulations).

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[6] The rule in section 14 of the IC Act which prevents reliance on a term if to do so would not be in the 'utmost good faith' indirectly addresses pre-contractual disclosure because it takes into account whether notification of the term was given. That rule is discussed below.

By way of example, the IC Regulations state that standard cover in respect of home contents insurance includes loss that is: '*caused by or results from - ... storm, tempest, flood, the action of the sea, high water, tsunami, erosion or landslide or subsidence*'.

If an insurer seeks to limit or exclude its liability in respect of the standard cover, then the insurer must prove that:

- it 'clearly informed' the consumer of the limitation or exclusion in writing before the contract was entered into (or within 14 days if provision before the contract was not reasonably practicable, e.g. telephone sales); or
- the consumer knew of the limitation or exclusion; or
- a reasonable consumer in the circumstances could be expected to have known of the limitation or exclusion.

If the insurer is unable to prove one of these three cases, then the insurer will be liable to make good any losses suffered by a consumer that were caused by, or resulted from, any of the standard events (construed in accordance with their ordinary meanings) up to a maximum limit (usually $2 million).

There have been a number of court and dispute resolution cases in relation to interpretation of 'clearly inform', which illustrate that although there could be various means to inform, provision to the insured of a policy document containing exclusions is sufficient, unless there are exceptional circumstances (for example, if the provisions in the policy are particularly confusing or complex). The court decision most cited on this issue (*Hams*) includes the following passage:

> *... a fair reading of s35(2) does not warrant the conclusion that the result need go further than provide for the relevant exclusion in the policy wording in clear and unambiguous language and in a manner which a person of average intelligence and education is likely to have little difficulty in finding and understanding if that person reads the policy in question.*

In practice, the standard cover regulations are very often rendered non-applicable by the provision to the insured of a policy document (usually contained within a PDS), thereby satisfying the requirement to 'clearly inform' the consumer. In a case where such a policy document was provided, the protection offered by section 35 would only be available if the terms in the policy were particularly complex or confusing.

Section 37 IC Act – notification of unusual terms

For other 'non-prescribed' types of contracts (which would include, for example, funeral insurance), there is no standard cover regime. However, insurers still need to 'clearly inform' insureds in writing, before a contract is entered into, of the effect of any terms '*of a kind that are not usually included in insurance contracts that provide similar insurance cover [to standard cover]*'. Failure to clearly inform an insured of such a clause (for example, an unusual exclusion or limitation) means the insurer is not permitted to rely on it later.

The use of section 37 may be limited as it only applies to provisions 'not usually included in contracts of insurance that provide similar cover'. So, if an exclusion or limitation is generally used in relation to the type of cover concerned, section 37 offers no protection, even if the insured was not clearly informed of the term.

PDS requirements under the Corporations Act

Pre-contractual disclosure requirements under the IC Act are commonly overlaid with requirements under the Corporations Act to provide clients with a PDS. The key criterion for this obligation to apply in relation to general insurance products is that the client is a 'retail client', as defined in Corporations Act and Regulations. This requires that:

- the acquirer of the product must be either an individual or a small business (fewer than 20 employees or 100 for manufacturing businesses); and
- the insurance product is within one of the following classes of insurance prescribed by the legislation and as defined in the regulations:
  - motor vehicle insurance;
  - home building insurance;
  - home contents insurance;
  - sickness and accident insurance;
  - consumer credit insurance;
  - travel insurance;
  - personal and domestic property insurance; or
  - another kind of general insurance product prescribed in the regulations (currently including medical indemnity insurance).

In addition, life insurance provided to retail clients is subject to pre-contractual disclosure requirements.

Accordingly, in general terms the PDS requirements apply to contracts prescribed for standard cover purposes under the IC Act, and some other classes of insurance. They do not apply, for example, to policies covering funeral insurance.

Corporations Regulation 7.9.15E requires a PDS for a retail insurance product to contain both the policy terms (other than the policy schedule), and any information that would be required under sections 35 and 37 of the IC Act.

A consequence of this requirement is that, for those life and general insurance products subject to PDS requirements, the 'clearly inform' requirements in sections 35 and 37 of the IC Act are supplemented by a 'clear, concise and effective' requirement which applies generally under the Corporations Act to material in PDS documents.

Future changes to disclosure rules

The current rules on pre-contractual disclosure have been considered in another context. On 5 April 2011, the Government released a paper seeking comment on a proposal to introduce a 'key facts statement' (KFS), which is intended to allow consumers to:

... quickly and easily check the basic terms of the insurance policy, including the nature of cover and any key exclusions.[7]

Legislation enacting the broad parameters of the proposal was passed by the Parliament on 21 March 2012. The scope of the KFS has been limited to home buildings and home contents policies and details for what will be included on the KFS will be progressed through regulations.

The introduction of a KFS will only seek to provide consumers with a high-level overview of what their insurance policy does and does not cover. As such, the KFS, in itself, will not address the issue of UCT in insurance, as it will not prevent potentially unfair terms from being included in an insurance contract.

Section 14 IC Act – Utmost good faith

Section 14 of the IC Act provides that neither party may rely on a term in a contract if to do so would be to fail to act with the 'utmost good faith'. This section is linked to pre-contractual disclosure, as subsection 14(3) provides that a court must have regard to whether any notification was given to the other party when deciding whether reliance by an insurer on a provision would breach the duty of 'utmost good faith'.

Under section 14, it is up to a policyholder whose claim is denied to bring an action (in a court or, more commonly, through the Financial Ombudsman Service) alleging the reliance on a term was in breach of section 14. A successful challenge to reliance on a term in dispute under section 14 would normally affect only the contract (and policyholder(s)) that were the subject of the case. The impact would usually be that the insurer would not be permitted to rely on the term in question for the purposes of denying an insurance claim.

Sections 53 and 54 IC Act – Rules on specific terms

The IC Act contains provisions that have the effect of rendering void certain terms, and preventing reliance by insurers on certain types of terms in certain situations.

Under section 53 of the IC Act, if a policy term allows the insurer to vary an insurance contract to the prejudice of a person other than the insurer themselves, the term is void. Regulations may be made to exempt certain classes of policy from the scope of the rule and a number of exemptions have been made in relation to life insurance and superannuation contracts, and certain types of commercial insurance contracts.[8]

Section 54 of the IC Act restricts an insurer from relying on terms of the policy that require an insured to do (or not do) some act after the contract was entered into. There are a number of elements to section 54:

If the act or omission could not be reasonably regarded as being capable of causing or contributing to the loss, the insurer cannot rely on a clause in the policy to refuse the claim on the basis of that act or omission unless it can prove actual prejudice (subsection 54(2)).

If the act or omission could be reasonably regarded as being capable of causing or contributing to the loss, but the insured proves that no part of the loss was caused by the act or omission, then the insurer can still not rely on the act or omission to deny the claim (subsection 54(3)). If the insured proves that

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7 Australian Government, *Reforming flood insurance: Clearing the waters*, p10, viewed on 28 April 2011, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1995

8 Regulation 31, Insurance Contracts Regulations 1985.

some part of the loss was not caused by the act or omission, the insured may not refuse to pay that part of the claim (subsection 54(4)).

If the act was necessary in order to protect the safety of a person or to preserve property, or if it was not reasonably possible to do the act, the insurer may not refuse the claim by reason only of the act (subsection 54(5)).

Sections 53 and 54 potentially address some instances of UCT. For example, a clause that required a policyholder to provide information about the circumstances of a claim that was not reasonably possible for the policyholder to obtain might be challenged as an unfair term. Alternatively, section 54 might be used to prevent the insurer from relying on the same term to refuse a claim.

Financial Ombudsman Service (FOS)

The FOS provides an independent external dispute resolution scheme in relation to a broad range of financial products and services, including life and general insurance. FOS provides a free, fair and accessible dispute resolution service for consumers and some small businesses who are unable to resolve disagreements with their financial services provider (where the provider is a FOS member). In making decisions in relation to an insurance dispute, FOS does what it considers fair in the circumstances of the case, having regard to relevant law, industry code of practice, good industry practice and previous decisions it has made. FOS decisions are binding on insurers but not on consumers, allowing consumers to take further legal action against the insurer if they disagree with FOS's decision.

FOS is also responsible for monitoring compliance with the General Insurance Industry Code of Practice, identifying and resolving systemic issues that arise and reporting them to ASIC.

FOS can make decisions that affect the terms of insurance contracts, particularly in relation to the above requirements for pre-contractual disclosure, 'utmost good faith' and reliance on specific terms. Decisions in relation to individual disputes can have broad impacts on contract terms through:

- the insurer involved in the dispute adapting terms in its contracts in response to a decision affecting the interpretation or application of the term; and
- other insurers adjusting their contract terms in response to a published FOS decision.

IMPLEMENTATION ASPECTS

Right to take action

If UCT laws are applied to insurance contracts, one implementation issue is the question of who would have standing to take action against insurers for breach of UCT laws.

Under the ASIC Act, ASIC or any party to the contract can apply to a court to have a term declared unfair.[9] However, in the insurance context, any additional uncertainty created by the risk of challenges to clauses that limit or exclude liability may have an impact on the future cost and availability of insurance for consumers, and the reinsurance of that risk by the insurer.

Consequently, this RIS includes a section with implementation options for the right to take action should UCT laws be applied to the insurance context.

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[9] Section 50, ASIC Act.

Consideration of 'main subject matter'

A further implementation issue if UCT laws are adapted to apply to insurance contracts is whether an exemption for the 'main subject matter' of a contract should apply and the scope of contract terms captured by its meaning.

Australia's existing UCT laws under the ASIC Act exclude the 'main subject matter' of a contract from the scope of review on the basis of unfairness. Under Section 12BI of that Act, terms that define the 'main subject matter' of a consumer contract, or otherwise relate the upfront price payable under the contract, are not subject to UCT provisions and therefore cannot be voided on account of unfairness.

'Main subject matter' is not explicitly defined in either the ASIC Act or the *Competition and Consumer Act 2010* (CCA), however, the explanatory memorandum of the CCA provides the following guidance:

> *5.59 The exclusion of terms that define the main subject matter of a consumer contract ensures that a party cannot challenge a term concerning the basis for the existence of the contract. [Schedule 1, item 1: Chapter 2, Part 2-3, paragraph 26(1)(a)]*
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> *5.60 Where a party has decided to purchase the goods, services, land, financial services or financial products that are the subject of the contract, that party cannot then challenge the fairness of a term relating to the main subject matter of the contract at a later stage, given that the party had a choice of whether or not to make the purchase on the basis of what was offered.*
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> *5.61 The main subject matter of the contract may include the decision to purchase a particular type of good, service, financial service or financial product, or a particular piece of land. It may also encompass a term that is necessary to give effect to the supply or grant, or without which, the supply or grant could not occur.*

Unlike other financial products or services where the 'main subject matter' can be clearly distinguished as the tangible thing purchased, the insurance contract itself is the financial service or promise purchased by consumers, making it difficult to define the components that truly reflect the 'main subject matter'. This creates the possibility that the insurance contract would not be seen as distinct from its underlying subject matter, and therefore entirely exempt from UCT laws.

However, as Clayton Utz notes in its advice to the ICA (presented to members at the 2011 roundtable), common law experience suggests that an insurance contract has 'subject matter' which is not itself the scope of cover. In *Wallaby Grip Limited v QBE Insurance (Australia) Limited; Stewart v QBE Insurance (Australia) Limited* [2010] HCA 9, the High Court stated that:

> *In insurance contract law an insurer promises to pay money to the insured if the circumstances stated in the policy exist. The insurer's promise may be equated with the cover provided by the insurance contract. The insured must prove such facts as are necessary to prove that the loss was covered by the contract, or as Bailhache J said in Munro Brice & Co v War Risks Association Ltd, the plaintiff must prove such facts as bring the claim within the terms of the insurer's promise.*
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> *Professor Malcolm Clarke in The Law of Insurance Contracts refers to three elements as ordinarily present in the circumstances necessary to the performance of the insurer's promise. The first is the insured event. Much may turn upon how it is described. The other two elements are the subject matter, which may be a class of persons, and the cause of the loss, usually referred to as the risk. The contract of insurance in this case identifies the insured event as the liability of the employer for injury to a worker arising at common law; the subject matter is workers, of whom Mr Stewart was one; and the risk was injury to a worker. Each of these elements was established. The question then is whether there is any other circumstance necessary to be established by Mrs Stewart before QBE could be said to be obliged to indemnify under the policy.*

In *CCH Australian and New Zealand Insurance Law Commentary* (2010) notes that:

> *A contract of insurance insures the interests of the insured in the subject matter of the insurance* and *the subject-matter of the insurance may be a physical item such as a house or a car; it may be a chose in action (which is a contractual or proprietary right enforceable by action) such as debt, contractual right or licence; it may be a potential legal liability such as one road-user's potential liability to other road-users for damage or injury caused by the former's negligence; or, as in the case of life, accident or sickness insurance, it may be a person.*

Clayton Utz advice also notes that it is difficult to separately identify the terms that define the scope of cover in an insurance policy. The scope of cover provided by a policy is determined by considering the interaction of several different provisions (including the insuring clause, policy schedule, definitions, qualifying exceptions and exclusions), for which there is unlikely to be a neat combination of categories for which UCT laws should apply.

Nonetheless, the definition of the 'main subject matter' of the insurance contract is an important consideration in determining the scope of contract terms that are subject to UCT laws and therefore the additional level of consumer protection afforded by the adaptation of UCT laws to insurance contracts.

Consequently, this RIS includes a section with a number of possible implementation options for 'main subject matter' should UCT laws be applied to the insurance context.

2. PROBLEM

There are conceptual reasons and some limited, mostly anecdotal, evidence that indicate some rare instances of UCT may be causing detriment to a small number of insurance consumers.

As identified by the Productivity Commission, in its 2008 *Review of Australia's Consumer Policy Framework,* market failures in relation to UCT more broadly include:

- *the use standard-form contracts* – as standard-form contracts avoid transaction costs in selling relatively homogeneous goods and services to large numbers of consumers, they effectively limit the incentives and capacity for consumers to negotiate the removal of specific, unfair terms;

- *disclosure does not mean contracts are read* - many disclosure documents for standard goods and services meet the legal requirement for disclosure and protect suppliers' interests, but are neither read nor intended to be read by consumers. Consumers are therefore unlikely to be aware of detailed terms and conditions of contractual arrangements;

- *assumed trust and lack of competition* - even if aware of unfair terms, consumers trust that these terms will not be exploited, or that they cannot avoid such terms through other providers as contract terms are standardised by the industry;

- *difficulty for consumers in reading and understanding terms* – contracts are often lengthy and difficult to understand, and consumers often have limited time to read and fully comprehend the contract;

- *consumers make systematic errors in appraising default risks* - unfair terms may result in the underinsurance of high cost, low probability events; and

- *markets underestimate ethical value* – positive externalities from avoiding unfairness are not captured by markets, resulting in lower than socially optimal ethical behaviour such as the inclusion of unfair terms in contracts.

While the Productivity Commission did not examine market failures for UCT specific to the insurance context, additional evidence suggests these failures exist to varying degrees in the market for insurance contracts.

- Almost all insurance contracts are standard-form contracts, which are not subject to genuine negotiation between the insurer and consumer. Contracts are typically drawn up by the insurer beforehand, rather than during negotiation, resulting in a lack of competition on contract terms with consumers either accepting contracts that contain unfair terms or not purchasing insurance policies at all.

  – Many insurance contracts are not directly entered into by the consumer but come as an additional feature of a purchase or investment. The most prominent example of this is insurance in superannuation, where the vast majority of life and TPD insurance policies are through superannuation.[10] As the Super System Review reported, 60 per cent of superannuation consumers do not make active choices with respect to their superannuation

[10] IFF & AIST Member Insurance Research in 2008 found that 96 and 67 per cent of people had life and TPD insurance cover respectively through their superannuation fund, while only 21 and 12 per cent respectively had such cover outside of superannuation.

(including their insurance arrangements), which suggests many insurance consumers have little understanding of their insurance cover until they need to make a claim.

: That said, many third party consumers would have the opportunity to adjust their insurance cover, including in relation to superannuation-provided insurance cover. However, some consumers do not have complete control over the choice of provider or terms of cover, including for example, an individual with home building insurance purchased under strata management.

– However, there are around 120 registered general and life insurance providers in Australia providing willing and able consumers a range of different contracts to compare and choose from. This enables some consumers to seek alternative arrangements that do not include undesirable standard-form terms.

- Consumers tend to focus on the cost of premiums when purchasing insurance and underestimate the importance of focussing on cover.

  – ANZ Survey of Adult Financial Literacy in Australia found that only 38 per cent of consumers taking out insurance for the first time consider the general level of cover, and only 11-12 per cent consider more detailed features such as benefits included or whether they would be underinsured. These factors are considered by about a third fewer people in the context of renewing a policy.[11]

  – A focus on premiums is expected to increase further with additional use of internet comparison sites that focus on premiums more than cover.

- Insurers satisfy disclosure requirements by providing written notice buried in the fine print of a complex and wordy PDS.

  – General insurance documents and PDSs may be anywhere between 20 to 80 pages in length and often reflect a confusing combination of multiple policies offered by the insurer.[12]

  – Test-based financial literacy research indicates that 46 per cent of Australians would struggle to understand comparatively simple documentation such as job applications, maps and payroll.[13] However, research based on self-reporting indicates that 82 per cent of people believe they have the ability and understanding to protect themselves and their assets by choosing appropriate insurance.[14] Combined, this research suggests that consumers overestimate their ability to understand insurance documentation.

- Many types of insurance policies are primarily purchased by telephone prior to the purchaser having the opportunity to see all the policy terms (although consumers are still entitled to a

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11 ANZ Survey of Adult Financial Literacy in Australia October 2011, available at: http://www.anz.com/resources/f/9/f9fc9800493e8ac695c3d7fc8cff90cd/2011-Adult-Financial-Literacy-Full.pdf.pdf?CACHEID=f9fc9800493e8ac695c3d7fc8cff90cd

12 National Disaster Insurance Review final report p99.

13 Australian Bureau of Statistics Adult Literacy and Life Skills Survey, Summary Results, Australia, 2006, available at: http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/4228.0Main%20Features22006%20(Reissue)?opendocument&tabname=Summary&prodno=4228.0&issue=2006%20(Reissue)&num=&view=

14 Financial Literacy Foundation, Financial literacy: Australians understanding money, Commonwealth of Australia, Canberra available at: http://www.financialliteracy.gov.au/media/209293/australians-understanding-money.pdf

cooling off period in which they can cancel a policy). Consequently, consumers often do not read PDSs before agreeing to an insurance contract.

  - For example, the majority of home insurance is purchased directly (rather than involving a broker or agent) and telephone sales are the preferred model for over 60 per cent of policies.[15]

  - A survey of 214 policyholders flooded in 2010-2011 indicated that only one policyholder had been sent a PDS prior to taking out the policy, 87 had received it after paying for the policy, and 54 reported that they did not receive it at all. [16]

- Consumers rely heavily on what is explained to them by insurer sales staff.

  - A recent survey of 126 policyholders assisted by the Caxton Legal Service after the 2011 floods showed that 32 per cent had only briefly read the policy documents because they had relied upon what was said to be important by the telephone sales staff. [17]

- Many consumers do not compare insurance providers or their products.

  - For the most commonly held types of insurance (motor vehicle and home building/contents), ANZ survey found that 43 per cent of consumers did not compare more than one insurer (of which 34 per cent only looked at one product). [18]

While the conceptual problem has been the focus of stakeholder representations and is reasonably well established, it is more difficult to clearly assess the extent of UCT and the detriment they cause. Despite several formal reviews of this issue (as outlined above) and extensive consultation with key stakeholders over the past two years requesting detailed evidence of UCT in insurance, available data does not provide a detailed perspective because:

- there is no comprehensive data that specifically identifies instances of policyholders who have been denied claims due to a UCT;

- data does not capture persons who have decided not to challenge terms that may be unfair because UCT laws do not apply to insurance contracts; and

- data does not reveal how many disputes are related to alleged unfair contract terms, or whether a claim based on UCT laws would have succeeded, if such laws had been in place.

Available data suggests UCT represent a very small problem in the insurance context.

- A review of FOS cases in the first quarter of 2012 listed as 'General insurance – Denial of claim – Exclusion/condition' and 'Life insurance – Denial of claim' identified 50 general and 8 life insurance disputes relating to the interpretation of policy terms.[19] Of these cases, 21 general and

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15 National Disaster Insurance Review final report p100.

16 National Disaster Insurance Review final report p100.

17 National Disaster Insurance Review final report p100.

18 ANZ Survey of Adult Financial Literacy in Australia October 2011, available at: http://www.anz.com/resources/f/9/f9fc9800493e8ac695c3d7fc8cff90cd/2011-Adult-Financial-Literacy-Full.pdf.pdf?CACHEID=f9fc9800493e8ac695c3d7fc8cff90cd

19 The finding of 50 general insurance disputes implies around 200 cases per year. This annual estimate is consistent with the implied number of general insurance cases per year from a general search of FOS cases for 2010 and 2011, which returned 176 and 227 disputes respectively.

4 life insurance disputes were resolved in favour of the consumer under existing laws, leaving an estimated 33 disputes per quarter that could be affected by UCT laws.[20]

- This suggests that only around 132 disputes per year (or 0.04 per cent of claims) could be affected by UCT laws.

- Note that while this provides an indication of potential disputes, it does not:

  : suggest the outcome of these disputes would necessarily be different under UCT laws, as many claims are denied on the basis of fair and reasonable contract terms. This would reduce the actual number of affected consumers; or

  : indicate the number of persons who have not made disputes but may do so under UCT laws. This would increase the actual number of affected consumers.

• General insurance claims data show that only a small fraction of claims are denied (although this data does not include the number of claims that are only partially paid or underpaid).

- During 2010-11, there were 31,937,791 personal general insurance policies issued or renewed.[21] In that year 3,251,179 personal general insurance claims were lodged and all but 55,776 of those claims (or 98 per cent) were paid. That is, consumers of only around 0.2 per cent of policies each year will be affected by a denied claim.

  : The proportion of denied claims differs for particular types of insurance, with it being reasonably high for some consumer credit and travel insurance (10.6 per cent and 8.7 per cent respectively) and above average for home building insurance (four per cent). This suggests the problem may be further limited to particular types of insurance.

- Around 39 per cent of denied claims are disputed by consumers, with around 10 per cent of total denied claims ultimately considered by the FOS. Disputes on their own are not evidence of UCT, however, they provide a broad indication of the number of cases of disagreement and uncertainty in respect of insurance contracts.

  : According to the 2010-11 Annual Review of the Financial Ombudsman Service, in that year the service dealt with 5,627 general insurance disputes and 905 life insurance disputes in 2010-11. Approximately 71 per cent of general insurance and 45 per cent of life insurance disputes related to a decision by the financial services provider, most commonly a decision to deny an insurance claim.[22]

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20 Review of cases listed on FOS website as of 3 April 2012, available at: http://www.fos.org.au/centric/home_page/cases/decisions.jsp

21 Financial Ombudsman Service, General Insurance Code of Practice Overview of the 2010-11 Financial Year, available at: http://www.fos.org.au/centric/home_page/about_us/codes_of_practice/general_insurance_code_of_practice.jsp

22 Financial Ombudsman Service, *2010-11 Annual Review,* available at: http://www.fos.org.au/annualreview/2009-2010/PDF/FOS_AR2009-10.pdf

: Around 78 per cent of the 21,544 general insurance disputes with insurers under the General Insurance Code of Practice last year related to claims, largely in relation to denial of claims. [23]

- In its submission in response to the 2011 draft RIS, the Consumer Action Law Centre suggested it had 94 inquiries in the last 12 months related to UCT.

- While the aforementioned Productivity Commission review provided estimates from Victorian complaints data that suggest the broader incidence of UCT could be relatively extensive, with as many as 30,000 cases per year in Australia of perceived detriment, it is not clear what proportion of these cases can be attributed to insurance contracts.

  – There is no conclusive evidence to suggest the incidence of UCT in insurance would be different to any other category of contracts, however, there are no estimates of the proportion of total contracts that relate to insurance on which to base a rough estimate from this data.

- In considering the available information on the number of claims affected by UCT, a rough estimate suggests there may be 75-150 consumers per year suffering disadvantage as a result of UCT in insurance.

Regarding the size of detriment caused by UCT, the limited available evidence suggests consumer detriment could be large in some individual cases, but is unlikely to be significant in aggregate.

- The maximum payout in the event of a claim could be significant for certain types of insurance, and as a result, so could be the financial risk to consumers. FOS data indicates that around half of all disputed claims (15 of the 29) found in favour of insurers related to home or home and contents insurance, most of which related to major claims for significant damage (almost total replacement).

  – For example, a family's main home represents 43.5 per cent of total household wealth or an average of $365,000 across all households. Once renters are excluded, the average value of owner-occupied homes is $531,000.[24] If an unfair term results in the denial of a home buildings insurance claim for the replacement value of the property (or an equivalent sum insured) following a catastrophic event (a natural disaster for example), it could be of significant detriment to the individual concerned, likely in the order of at least $200,000-$250,000 for a house of average value.

    : However, the prevalence of underinsurance means there is a significant distinction between the amount insured and optimal insurance (for example, the replacement value of a property), which reduces potential loss from denied claims due to UCT. For example, the Insurance Council of Australia (ICA) noted that the average claim for

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23 Financial Ombudsman Service, General Insurance Code of Practice Overview of the 2010-11 Financial Year, available at: http://www.fos.org.au/centric/home_page/about_us/codes_of_practice/general_insurance_code_of_practice.jsp

24 ABS catalogue 6554.0, *Household Wealth and Wealth Distribution*, available at: http://www.ausstats.abs.gov.au/ausstats/subscriber.nsf/0/51342DFD54324472CA257928001107B4/$File/65540_2009-10.pdf

homes that were total losses from the Victorian bushfires was $132,000 compared with an average cost of building a home in Victoria of $230,000.[25]

- Similarly, a survey in 2008 found that average life insurance cover was for a payout of $189,000.[26]

- The financial loss currently impacting consumers is difficult to quantify in the absence of conclusive data. Based on FOS data, most of the home and home and contents claims were for significant damage (almost total replacement), while remaining claims were generally in the order of $1,000-$10,000 where the amount claimed was specified. While there is insufficient data to provide an accurate estimate of overall loss, assuming UCT laws would affect an equal proportion of cases in each category of insurance and the average loss is around $67,500[27], total loss for 75-150 consumers could amount to between $5-10 million per annum.

Submissions from consumer representatives in response to the 2011 draft RIS and previous consultation processes provided a number of examples of insurance contract terms which may be unfair. Whether the terms in these particular examples would be 'unfair' under UCT laws is not clear, however, they illustrate three particular aspects of UCT laws of concern in the insurance context:

- whether some insurance contract terms are reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term (see paragraph 12BG 1(b) of the ASIC Act provisions at Appendix A);

  - An example may include where policy provisions that ignore practical barriers to insureds meeting their obligations, such as:

    We will not pay a claim in relation to your Luggage and Personal Effects if you do not report the loss, theft or damage within 24 hours to the police or an office of the bus line, airline, shipping line or rail authority you were travelling on when the loss, theft or misplacement occurred. You must prove that you made such report by providing us with a written statement from whoever you reported it to;

- whether a term permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract (see s12BH(1)(a) of the ASIC Act provisions at Appendix A):

  - Examples of this may include:

    : A policy under which an insurer can deny a claim if the policyholder had failed to comply with all relevant Australian Standards, noting that there are around 7,000 Australian Standards and these are not available free of charge.

    : A mature-aged traveller was denied cover for cancellation of a trip due to undergoing coronary surgery, on the basis that heart problems experienced 20 years earlier were a pre-existing condition (see box 1 for case study);

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[25] ICA, Submission to the 2009 Victorian Bushfires Royal Commission responding to the Royal Commission's discussion paper entitled 'The Fire Services Levy and Insurance', January 2010.

[26] IFF and AIST member research available at: http://www.aist.asn.au/media/2245/aist_2008.06.03_research_IFF&AIST_member_insurance_research.pdf

[27] Assuming average home and home and contents claims of around $130,000 (based on ICA estimates from Victorian bushfires) account for half of all cases and average other claims of around $5,000 (based on FOS cases) account for the other half of all cases.

: A consumer whose luggage was stolen after he boarded a city transfer bus at Hong Kong airport and placed his luggage in the luggage rack on the lower level of the bus but sat on the top deck had his claim denied because he did not keep the luggage under observation (see box 1 for case study);

- whether a term is transparent (see subsection 12BG(3) of the ASIC Act provisions at Appendix A); and

  – An example of a term that is not transparent may include a farm property, contents and equipment policy that excluded liability for *personal injury or damage to property directly or indirectly caused by or arising out of…a hobby farm* under which a 'hobby farm' is not clearly defined or understood.

- whether the IC Act protections appropriately protects against standard form contracts.

Submissions in response to the 2011 draft RIS and broader consultation processes on this issue illustrate the disagreement between key stakeholders on the extent and impact of unfair terms in insurance contracts.

- Insurers and their representatives dispute the existence of unfair terms and argue the existing regulatory regime provides appropriate safeguards for consumers.

- Consumers and their representatives strongly believe that unfair terms exist in Australian insurance contracts and that they are causing Australian consumers harm.

- FOS's submission in response to the 2011 draft RIS stated that FOS did not believe the existing laws provide complete protection for consumers against UCT, that gaps existed.

In summary, there are conceptual reasons that suggest UCT may be causing detriment to insurance consumers and some (albeit limited) evidence to suggest UCT are resulting in a small aggregate financial loss for a small number of consumers.

Box 1: Examples of disputed insurance contract terms

The following two examples demonstrate cases of perceived unfairness in policy exclusions and the opposing outcomes determined by FOS demonstrate uncertainty in the interpretation of 'utmost good faith' in respect of fairness.

Case 1: Mature-aged traveller (relates to FOS determination 23662)

In 2005, an 83 year old man was denied an $11,000 claim on a travel insurance policy for the cancellation of his trip due to heart surgery. The insurer denied the claim on the basis that heart surgery related to an existing health disorder (an ongoing or chronic condition), where such pre-existing conditions are excluded under the policy.

While the policyholder had treatment for heart conditions between 1986 and 1989, he had no signs, symptoms or treatment for a heart condition for the 16 years between then and the surgery in 2005. He had a healthy and active life during this time, had no more than standard annual or half-yearly check-ups and was only taking preventative medicine.

When taking out the policy, his good health over the previous 16 years convinced him there was no health problem to disclose. The application for the cover did not ask any questions as to medications that were prescribed for him and he does not consider it is reasonable he is required to read the policy to understand the cover provided.

Recognising the above, that the policy was specifically for 70 to 84 year olds, and that the policy separately noted that hypertension is not a chronic condition, FOS determined in favour of the policyholder.

Case 2: Hong Kong luggage theft (relates to FOS determination 37465)

In 2008, a traveller boarded a city transfer bus at Hong Kong airport and placed his luggage in the lower level luggage rack. The applicant then proceeded upstairs to the top deck of the double decked bus. Upon his return to the lower level of the bus, the applicant noticed that his luggage had been stolen.

The traveller's claim on his insurance policy was denied by his insurer on the basis that the luggage was left unsupervised in a public place, a circumstance which forms an exclusion under the policy terms and conditions. The policy exclusion in question stated that: 'You (the policyholder) must take all reasonable precautions to safeguard your Luggage and Personal Effects. If you leave your luggage and Personal Effects Unsupervised in a Public Place we will not pay your claim.

In appealing to FOS, the traveller argued that his luggage was stolen right out from under his nose, that this was why he had purchased travel insurance, to cover circumstances such as this as it is a popularly held belief by travellers that this type of incident would be covered. The traveller noted that by law, he was required to place his luggage in the racks on the lower level and he then proceeded, in knowledge that his luggage was watched by CCTV, upstairs to the upper deck of the double decked bus.

FOS decided in favour of the insurer, noting that whilst it may have been reasonable or required for the traveller to have placed the luggage in the luggage racks, it is reasonable to expect that the traveller, in compliance with his policy terms and conditions, would have sat downstairs in close proximity to his luggage which the applicant has advised was possible. The traveller did not keep the luggage under observation, he was not in a position to observe anyone interfering with it as he did not see it being taken and accordingly he was not placed to attempt to prevent the theft.

3. OBJECTIVES

The objective is to promote an insurance market that works to enhance consumer confidence and wellbeing. A well-functioning insurance market should protect consumers from the unfair diminution of rights under contractual arrangements developed in the absence of genuine negotiation. Consumers purchasing standard insurance products should have confidence that the contract they have entered into accurately reflects the insurance cover agreed upon with the insurer and that consumers have appropriate remedies when they suffer detriment as a result of UCT.

4. OVERARCHING APPROACH TO INTRODUCING UCT LAWS TO INSURANCE

4.1 OPTIONS

While there are several aspects to consumer protection policy (both for insurance consumers and other consumers) intended to address the market failures identified in the 'Problem' section, this RIS considers options in relation to one particular element of consumer protection – possible remedies for cases of UCT in the insurance market.

UCT laws applying to other financial products and services provide quite specific protection against contract terms (other than those relating to the main subject or price under the contract) that are unfair (that is, not transparent, unnecessary, unbalanced or could cause detriment to a party if relied on) in relation to a 'consumer contract' (a contract relating to an acquisition predominantly for personal, domestic or household use or consumption) of a 'standard form' (a contract determined by one party with unequal bargaining power in the absence of negotiation and discussion).

Options for applying UCT laws in the insurance context would seek to:

- address terms in insurance contracts that are unfair or able to be interpreted unfairly;
- protect consumers that are unable to understand terms and the risk associated with them;
- improve incentives for insurers to improve the clarity and transparency of contract terms; and
- provide appropriate avenues of recourse for ASIC and consumers against cases of UCT.

Options considered in this RIS do not attempt to:

- consider broad reforms to the disclosure of contract terms;
- consider ways to improve consumer engagement with and understanding of contract terms; or
- address competition and negotiation in the market for insurance products.

As noted in the 2011 draft RIS, extensive consideration has been given to other options since consultation recommenced in early 2010, including a specific list of prohibited unfair terms, a co-regulatory regime and improvements to broader consumer protection mechanisms. However, these options are no longer being considered because they:

- would not meet the government's objectives specific to UCT laws for insurance contracts, including to protect consumers from the unfair diminution of rights and provide consumers with appropriate remedies when they suffer detriment as a result of UCT;

- would be impractical to implement; and/or

- go beyond the scope of the policy issue identified by government.

Another option that was considered was to engage in consumer education campaigns. While this option may raise awareness of the possibility of unfair terms in insurance contracts, it would not provide a remedy for consumers who suffer detriment as a result. For those consumers who identify potential unfair terms before purchasing an insurance policy, it may be difficult for those consumers to 'shop around' when a particular term is standard across insurers. This option would not specifically address the Government's object of protecting consumers from the unfair diminution of rights under contractual arrangements and ensuring consumers have appropriate remedies for any detriment suffered from UCT.

The RIS will consider a number of different options to meet the Government's objectives. Options A to D consider options for the overarching approach to meet these objectives. If UCT laws were to be extended to insurance contracts (Option C or D), two other factors must be considered:

- who will have the right to bring a claim against an insurer under the laws (Options I and II); and

- how will the exemption from the UCT laws for the 'main subject matter' of the contract be defined (Options 1 to 4).

That is, Options I and II, and Options 1 to 4 will only be relevant considerations if Options C or D are chosen for the overarching approach.

In terms of specific options considered for the overarching approach, this section assesses the effectiveness of four options which were also outlined in the 2011 draft RIS. A summary of the four options is as follows:

- Option A maintains the status quo where there would be no measures put in place to enhance consumer protection from the potential of unfair terms in insurance contracts – consumers would be reliant on existing remedies in the IC Act;

- Option B enhances existing remedies in the IC Act, including enhancement of the existing duty of 'utmost good faith';

- Option C makes amendments to the IC Act to allow the direct application of the existing UCT laws in the ASIC Act to apply to insurance contracts (currently restricted by section 15 of the IC Act); and

- Option D makes amendments to the IC Act by implementing a separate set of UCT laws for insurance contracts – these UCT laws would largely mirror those which exists in the ASIC Act with certain tailoring.

Option A: Maintain the status quo

Option A would maintain the existing regulatory regime in the IC Act which does not include any provisions directly addressing unfair contract terms.

The existing safeguards for consumers, outlined in more detail above, would remain in force including:

- IC Act provisions;
  - s13 and 14 - neither party may rely on a term in a contract if to do so would be to fail to act with the utmost good faith;
  - s35 - 'standard cover' rules for certain types of prescribed household/personal contracts;
  - s37 - notification of 'unusual terms' rules for other contracts;
  - s53 - if a policy term allows the insurer to vary an insurance contract to the prejudice of a person other than the insurer themselves, the term is void; and
  - s54 - an insurer cannot rely on terms of the policy that require an insured to do (or not do) some act after the contract was entered into.
- Corporations Act provisions; and
  - prohibiting misleading or deceptive conduct, unconscionable conduct, and the making of false or misleading representations; and
  - extensive licensing, disclosure and conduct regime in respect of the issue, sale and distribution of financial products, including contracts of insurance policies.
- External Dispute Resolution Schemes (such as FOS) as the key avenue for consumers to take action.

As Option A maintains the status quo, it would not effectively address any of the concerns with UCT outlined in the problem section. As a result:

- a small number of consumers may continue to suffer detriment as a result of unfair contract terms and a larger number of consumer may continue to be exposed to the risk of detriment;
- insurance consumers would not have equivalent protection to consumers of other financial products and services; and
- insurance contracts will continue to not be subject to the same scrutiny as contracts for other financial products.

While Option A itself has no additional benefits or costs, it provides a basis for illustrating and comparing the costs and benefits of the other options.

Option B: Enhance existing IC Act remedies (revisit IC Act 2010 Bill)

In March 2010, the Insurance Contracts Amendment Bill 2010 (ICA Bill) was introduced into the Parliament. The ICA Bill did not pass the Senate before the calling of the federal election in July 2010, and the Bill lapsed. The ICA Bill did not specifically deal with UCT laws, but contained amendments to the IC Act that would improve the effectiveness of the 'utmost good faith' requirement. This Bill has

not been reintroduced into Parliament however a revised version was released for exposure on 29 November 2012.

Option B would build on existing remedies in the IC Act, particularly section 14, as proposed in the ICA Bill. Section 15 of the IC Act would continue in operation so that the UCT provisions of the ASIC Act would not apply.

Changes to section 14 of the IC Act would include:

- the extension of the duty of 'utmost good faith' to third party beneficiaries, as proposed in the 2010 IC Act Bill;
- a proposed facility for ASIC to bring a public interest action for a breach of section 14, as proposed in the 2010 IC Act Bill;
- reversing the onus of proof, so where an insurer is relying on a term in the contract that is the subject of an allegation by a policyholder / third party beneficiary that it is in breach of the duty of utmost good faith, the insurer would be required to demonstrate that reliance on the term is not in breach of section 14; and
- implementing a blanket ban on terms found to be in breach of the duty of utmost good faith under section 14.

Option B would address some of the deficiencies in respect of the 'utmost good faith' requirement, which would benefit consumers by:

- extending protection to more consumers (third party beneficiaries);
- transferring burden of proof to insurers; and
- enabling ASIC to protect consumers in cases of widespread detriment.

However, under Option B, the concept of fairness would only be considered in the context of the application of the 'utmost good faith' test. As a result, Option B would not address the same issues as UCT laws.

To explain this further, there has been considerable debate regarding whether the 'utmost good faith' requirement in and of itself provides equivalent protection to UCT laws. While conceptually the exclusion of unfair terms from contacts would appear to be consistent with acting in the 'utmost good faith', evidence from case law and FOS disputes suggests the 'utmost good faith' requirement is met by simply meeting disclosure requirements. To the extent that UCT are simply disclosed and not negotiated or adequately explained to insureds, they would not be captured by the 'utmost good faith' requirement. In contrast, the existing UCT laws under the ASIC Act (explained above) apply irrespective of whether disclosure requirements have been met.

It is also worth noting that FOS, as the dispute resolution body charged with applying a general test of fairness to insurance disputes, believes that existing law does not enable it to deal with all cases of UCT.

Similar to Option A, under Option B:

- a small number of consumers may continue to suffer detriment as a result of unfair contract terms and a larger number of consumer may continue to be exposed to the risk of detriment;
- insurance consumers would not have equivalent protection to consumers of other financial products and services; and

- insurance contracts will continue to not be subject to the same scrutiny as contracts for other financial products.

Option C: Permit the UCT provisions of the ASIC Act to apply to insurance contracts

The operation of the UCT laws in the ASIC Act is affected by section 15 of the IC Act, which prevents provisions of other Acts from applying to insurance contracts where they would contest the contract on the ground that it is harsh, oppressive, unconscionable, unjust, unfair or inequitable.

Option C would amend section 15 of the IC Act to permit the current UCT provisions in the ASIC Act to apply to insurance contracts in addition to, and alongside, the IC Act remedies. That is, the existing UCT laws under the ASIC Act (which are at Appendix A) would apply to insurance contracts.

Under Option C, equivalent UCT laws would apply across all financial products and services, enabling the courts, FOS and regulators to take a consistent approach to UCT issues applying to all contracts for financial products and services including insurance. While it is too early to assess the effectiveness of these provisions in the Australian context (given the short time elapsed since their introduction), similar UCT laws in the United Kingdom (UK) have effectively eliminated some cases of consumer detriment.

The effectiveness of this option would also depend significantly on the scope of the definition of 'main subject matter', which is excluded from consideration under UCT laws. Consequently, the broader the definition of 'main subject matter', the fewer contract terms that would be able to be considered under the UCT laws.

This option would apply to new and renewed contracts entered into after a transition period.

However, the direct application of UCT laws in the ASIC Act is likely to result in some degree of confusion for both insurers and consumers due to the definition of 'consumer contract' in the ASIC Act being different to the definition of 'contract of insurance' under the IC Act.

Option D: Extend IC Act remedies to include UCT provisions

Under Option D, the IC Act would be amended to include remedies relating to UCT based on the principles of the UCT laws under the ASIC Act. While most of the actual ASIC Act provisions would be included in the IC Act, some of those provisions would be tailored to ensure UCT laws fit within the existing consumer protection regime for insurance contracts, reducing potential uncertainty with Option C.

The IC Act would continue to be the primary source of regulation regarding insurance contracts and specifically, Option D would involve the following tailoring:

- The contracts that would be subject to UCT laws would be limited to consumer 'contracts of insurance' that are regulated by the IC Act. This is required because UCT laws in the ASIC Act apply to 'consumer contracts' (as defined by subsection 12BF(3)) which does not properly address how packaged personal and business insurance contracts interact with the UCT laws;

- Standard cover terms defined in IC regulations could not be deemed unfair as they fall under the exclusion of a term that is required, or expressly permitted, by a law of the Commonwealth or a State or Territory.

  - Exclusions or limitations to standard cover terms may be subject to a test of unfairness if they do not form part of the main subject matter exclusion (options to define 'main subject matter' are set out in Part 6 of this RIS);

- Whether a contract term is unfair under the UCT laws would be one necessary component of determining whether an insurer has acted in 'utmost good faith', but would not otherwise unwind this duty. The consequences of breaching UCT laws (and thus the 'utmost good faith' requirements) would be that the insurer could not rely on the term in that individual contract. This is consistent with the operation of other IC Act remedies.

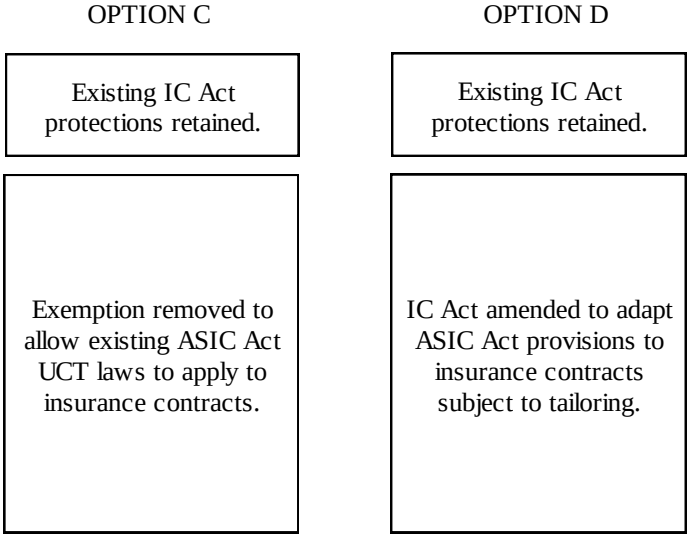
- Consideration would also be given to whether insurers have the ability under existing laws, or whether additional tailoring would be required, to vary contract terms prospectively if a term that is common across contracts if found to be unfair.

Otherwise, the existing UCT laws under the ASIC Act would be included in the IC Act as outlined in Appendix A.

For the sake of consistency between the application of the UCT laws in the ASIC Act and the IC Act, ASIC or a consumer would also have the ability to seek a court declaration that a contract term is unfair[28]. Such declaratory orders could be used for example, to address widespread contractual unfairness. The ability of ASIC to make such an application would be in addition to the right to bring action against an individual insurer (Options I and II discuss whether a consumer should also have the right to bring an action against an individual consumer). In practice, ahead of making an application, it would be expected that the regulator would seek to have the insurer reconsider the future use of a term in a standard contract if a court has declared that to be unfair in proceedings brought by a consumer.

[28] Section 12GND of the ASIC Act introduced as part of the UCT laws.

Figure 1 below illustrates the key difference between Options C and D.



This Option would apply to new and renewed contracts entered into after the end a transition period.

Option D would ensure the principles underpinning the UCT laws would be the same across all financial products and services, while ensuring UCT laws fit within the existing insurance market protections. Two sets of UCT laws will exist for financial products – one for insurance contracts and one for other financial products – however, the tailoring of UCT laws to insurance contracts may reduce uncertainty in determining how the UCT laws under the ASIC Act would apply to insurance contracts (as may be the case under Option C).

4.2. IMPACT ANALYSIS

Option A: Maintain the status quo

Impact on consumers

As Option A does not change the current regulatory environment, it would not result in benefits or costs for consumers who suffer actual or potential detriment as a result of UCT.

From our assessment of the limited available evidence and data (as outlined in the 'Problem' section of this RIS), we believe a small number of consumers suffer disadvantage or loss as a result of UCT in insurance and would continue to do so under this option.

As noted in the 'Problem' section, a review of FOS data indicated that there may be 75-150 consumers per year suffering disadvantage as a result of UCT in insurance which would equate to between $5-10 million per annum. These figures could potentially be higher in times of widespread natural disaster.

This estimate is not intended to accurately depict the current impact of UCT, but provide a rough illustration of the potential detriment caused by UCT in the absence of more reliable estimates. In addition, not all consumers will be subject to an event which gives to rise to a claim under their insurance policy. As a result, not all consumers will suffer detriment due to UCT but would otherwise be exposed to risk of such detriment. There is limited data available on the risk of detriment that consumers face, however it is expected that greater than 75-150 consumers face such a risk. As will be

discussed in respect of Options C and D, the estimated impact on consumers from what are referred to as UCT will depend heavily on the definition of 'main subject matter'.

Impact on insurers

As Option A does not change the current regulatory environment, it would not result in benefits or costs for insurers.

Insurers would not have to review existing contracts for unfair terms or face potential costs from additional legal action resulting from the introduction of UCT laws (see Options C and D for details).

Impact on other stakeholders

As Option A does not change the current regulatory environment, it would not result in benefits or costs for other stakeholders, including insurance brokers and agents, reinsurers or government agencies.

In particular, ASIC would not gain additional powers to address concerns with UCT in insurance (see Options C and D for details).

Option B: Enhance existing IC Act remedies (revisit IC Act 2010 Bill)

Impact on consumers

Generally, consumers would benefit from:

- additional protection for third party beneficiaries under the 'utmost good faith' requirement;
- the transfer of burden of proof costs to insurers; and
- ASIC acting in the public interest to protect consumers in cases of widespread detriment.

As costs to insurers are not expecting to significantly increase (due to little change in the operating environment) it is not expected that costs to consumers would also.

However, a small number of consumers would continue to suffer detriment consistent with the estimates provided under Option A, as Option B would not specifically address concerns with UCT.

Impact on insurers

Generally speaking, there would be minimal additional costs for insurers under this Option. Additional costs would arise if insurers have to fund the costs of additional disputes that might arise under broadened 'utmost good faith' provisions.

There may be minor benefits for insurers under this Option, as:

- giving ASIC broader powers to take action may reduce the number of individual cases insurers have to fund; and
- insurers will benefit from greater clarity regarding 'utmost good faith' requirements for third party beneficiaries.

Impact on other stakeholders

ASIC would benefit from additional powers to act in the public interest where it believes insurers have not acted with 'utmost good faith'.

ASIC will administer UCT for insurance contracts in line with its current responsibilities in respect of UCT and the IC Act.

Option C: Permit the UCT provisions of the ASIC Act to apply to insurance contracts

Impact on consumers

Option C would be expected to provide protection for consumers from potential or actual disadvantage or loss resulting from unfair terms in insurance contracts. Reflecting the estimates provided under Option A, this could benefit up to 75-150 consumers between $5-10 million a year and reduce the risk of exposure to UCT to all consumers (whether or not an event gives risk to making a claim).

However, the impacts of implementing Option C will depend heavily on the scope of 'main subject matter', which will be determined in a later process if this option is progressed. An illustration of the potential impact of 'main subject matter' is provided through an assessment of the two extreme cases:

- If the scope of 'main subject matter' is as broad as possible, such that all insurance contract terms are interpreted as being part of 'main subject matter' and exempt from UCT laws, the introduction of UCT laws would have no impact on those consumers that suffer actual or potential detriment as a result of UCT. That is, the benefit to consumers of this option would be zero.

- If the scope of 'main subject matter' is defined as narrowly as possible or not included in UCT laws for insurance, such that it does not capture any contract terms, the introduction of UCT laws would be expected to include all of the 75-150 estimated cases and all consumer who would be exposed to the risk of detriment.

Option C may also benefit these consumers through the additional security of knowing that they and ASIC have additional recourse to take action against insurers who include unfair terms in contracts and, more broadly, the lower risk of entering into an insurance contract. As the majority of consumers focus on premiums, rely on standard form contracts to accurately represent their cover, and prefer simple methods for acquiring insurance (such as telephone sales and increasingly internet comparisons)[29], UCT laws will also provide a safeguard consistent with consumer purchasing behaviour, further empowering consumers to confidently enter into insurance arrangements.

Submissions from insurance representatives suggest that the introduction of UCT laws in insurance would result in additional costs for insurers when seeking reinsurance (as a result of greater risk of exposure to liability), which in turn could translate to possible increased premiums for consumers and reduced affordability of insurance. In addition, it is likely that legal costs would rise for insurers as a result of cases brought against them on the basis of unfair terms.

These submissions did not substantiate their claims with quantitative estimates of the impact on insurance premiums, noting that effects would be difficult to predict in the absence of detailed legislative proposals and uncertainty in respect of what would be deemed unfair by the courts. An assessment of the impact following the introduction of UCT laws in the UK and the lack of cases in Australia under existing UCT laws provides no evidence of a significant impact on insurers or insurance premiums. However, such an impact will also depend on the scope of 'main subject matter' as discussed above.

Submissions from insurance representatives also suggested that the 'blanket' banning of terms may not be in the best interests of all insureds. While ASIC will have the power to take action against cases of widespread disadvantage caused by commonly used unfair terms, such cases are expected to be

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[29] See references provided in the 'Problem' section of this RIS.

rare relative to individual cases. In addition, this argument suggests unfair terms are justified by reduced premiums for the majority of consumers that do not make claims, which is a flawed argument for both ethical and economic reasons – the latter reflecting that an estimated 75-150 cases worth $5-10 million would not have a meaningful impact on premiums.

Submissions from insurance representatives also argued that unfair terms may limit access to cover in risky market segments. While this issue is most relevant to and dependent on the consideration of 'main subject matter', UCT laws ensure insurers' maintain the ability to define terms in relation to core coverage and key risks.

In any case, it is arguable that insurers, in reassessing standard contract terms, will act conservatively and use terms that will not expose them to significant risk of liability. ASIC is likely to provide guidance on UCT laws and insurers may engage with ASIC to provide discussions on the interpretation and application of UCT laws. Therefore, the ongoing costs to insurers, including of reinsurance could be mitigated by taking these steps.

Impact on insurers

As discussed above, Option C is likely to involve additional costs for insurers in relation to:

- understanding the application of the legislation, including assessing the application of the definition of 'consumer contract' (which the UCT laws in the ASIC Act apply to) to 'contracts of insurance' (which the Insurance Contracts Act applies to);
- reviewing and making any necessary amendments to contracts;
  - in its supplementary submission to Treasury in response to the 2011 draft RIS, the ICA notes that '*insurers would need to assess their contracts for terms that may be considered unfair but this should be manageable given that such terms are already subject to a range of strong consumer protections*'.
- additional costs relating to internal reviews, FOS disputes and court action; and
- possible application of blanket bans.

These potential costs are difficult to quantify, as there is significant uncertainty in respect of likely additional court action and submissions have been unable to provide estimates of the expected impact. Expected costs for insurers are not likely to be high, reflecting that:

- UCT and cases of consumer detriment from these terms are unlikely to be widespread (noting the above estimates of consumer detriment);
- Experience with UK and Victorian UCT laws suggests minimal, largely one-off costs for business.
  - The Productivity Commission estimated that a large business would have a primarily one-off cost of around $30,000 in negotiating and updating contracts to comply with UCT laws, which equates to an annual cost of around $2,000. The Productivity Commission also cited a regulatory impact statement developed by the UK Department for Business, Enterprise and Regulatory Reform which estimated *'(mainly upfront) compliance costs of around £15-£35 per business.'*
- The costs incurred by insurers in most cases can be reduced through less costly means of settling cases. The majority of claims disputes are resolved directly between the insurer and consumer,

and almost all of the remainder are resolved by the FOS, which is a far cheaper alternative to court action.

- The cost of FOS action for the insurer depends on the complexity of the case and the level of intervention required (whether it can be resolved in initial negotiation or requires a determination). Costs range from around $2,000-16,000 per dispute.

- In comparison, an Attorney General's department report estimated average Federal Court costs for a respondent to a civil law case at almost $100,000 per case in 2007-08, within a significant range between individual cases from a few hundred dollars to over $2 million.[30]

A rough estimate based on the Productivity Commission figures would suggest that if the annual cost for all insurers (of which there are approximately 120 unique general and life insurers) is estimated at $2,000 per year, the total annual changeover cost would be about $240,000. However, the potential costs to insurers of adjusting to UCT laws will be partially mitigated by providing a reasonable transition period to prepare for the changes.

As noted above, it is similarly difficult to estimate the cost of additional disputes or legal action against insurers. In the above rough estimates of cases based on FOS data, it is assumed a small number (18) of possible additional FOS disputes resulting from the introduction of UCT laws. At a cost of between $2,000-16,000 each, the estimated additional cost would be between $36,000-288,000 per year for the total insurance industry. The cost of rare cases of additional court action is too uncertain to provide a meaningful quantitative estimate.

In addition, as noted above, it is arguable that insurers may mitigate any increase in costs through reinsurance by taking a reasonable and conservative approach in assessing its standard contract terms and engaging in discussions with ASIC.

There may be some small, unquantifiable benefits for insurers resulting from:

- increased consumer confidence in the insurance industry, which may in turn lead to increased rates of insurance uptake; and

- reduced disputes regarding breach of 'utmost good faith' if the incidence of disputed terms is reduced.

Impact on other stakeholders

ASIC would have an additional avenue to address UCT laws in insurance. This will improve the effectiveness of ASIC as the regulator for consumer protection across all financial products and services.

ASIC will administer UCT for insurance contracts in line with its current responsibilities in respect of UCT and the IC Act. Any additional costs to ASIC are likely to be small, as a proportion of its existing resources are dedicated to enforcing UCT laws for other financial products and services.

Insurance brokers and agents will also benefit from the knowledge that contracts should have been reviewed for fairness, particularly brokers who are expected to represent the interests of consumers.

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30 'A Strategic Framework for Access to Justice in the Federal Civil Justice System' page 51, available at: http://www.ag.gov.au/Documents/A%20Strategic%20Framework%20for%20Access%20to%20Justice%20in%20the%20Federal%20Civil%20Justice%20System%20-%20Report%20of%20the%20Access%20to%20Justice%20Taskforce.pdf

However, these stakeholders may have some minor additional costs related to training and further understanding of insurance contracts that are revised as a result of UCT laws, although this is unlikely to be widespread.

Option D: Extend IC Act remedies to include UCT provisions

Impact on consumers

The impact of Option D would be the same as that for Option C for those consumers who suffer actual or potential detriment as a result of UCT, with the following exceptions:

- consumers would benefit further from the tailoring of UCT laws to the insurance context. This includes the tailoring of the contracts that would be captured under the IC Act by the UCT laws so that they cover a broader range of consumer-related insurance contracts than would otherwise apply under the existing definition of 'consumer contract' under the ASIC Act (under Option C);

- tailoring would also mitigate the potential costs for insurers, reducing the likelihood of increased premiums and reduced availability of coverage passed on to consumers;

- consumers would not benefit from consistency of UCT laws across all financial products and services (under Option C), although they would benefit from equivalent protection which is offered under Option D.

Impact on insurers

The impact of Option D on insurers would be the same as that for Option C, except:

- tailoring UCT laws to the insurance context would reduce uncertainty for insurers, reducing associated costs of understanding the application of UCT laws in the ASIC Act to insurance contracts;

- if a term is found to be unfair, the immediate impact on insurers will not be as widespread compared with Option C;

- tailoring UCT laws to insurance would also mitigate potential costs relating to action against insurers under multiple sets of legislation, in particular where insurers rely on the standard cover provisions in the IC Regulations;

- retaining the existing wording of section 15 of the IC Act (which prevents remedies outside of the IC Act to be used for matters relating to insurance contracts) would ensure there are no unintended consequences for insurers relating to relief from other legislation (particularly state and territory legislation – which was raised as a concern by submissions); and

- it would apply to a greater range of insurance contracts, which may marginally increase the number of potential disputes and costs for insurers.

Overall, it is expected that tailoring will reduce costs for insurers from the introduction of UCT laws, however any increase in uncertainty for insurers as to what constitutes a UCT may have an impact on the cost of reinsurance. The difference is difficult to quantify as insurance representatives have been unable to provide estimates, however, the insurance industry prefers Option D to Option C due to the expected mitigation of potential costs.

In addition, as noted above, it is arguable that insurers may mitigate any increase in costs by taking a reasonable and conservative approach in assessing its standard contract terms, referring to ASIC guidance and engaging in discussions with ASIC. For example, there is the opportunity for insurers to

reconsider the terms of their contracts against the unfairness criteria and make any necessary changes to avoid having terms considered through litigation.

Impact on other stakeholders

As with Option C, ASIC would have an additional avenue to address UCT laws in insurance. As a result, this would improve the effectiveness of ASIC as the regulator for consumer protection across all financial products and services against unfair terms. The role of ASIC would be:

- to provide guidance to insurers, both collectively and on an individual basis as required, on the application of the UCT provisions to insurance;
- to engage with insurers to make prospective changes to their contracts to address terms that are determined by a court to be unfair; and
- where necessary, take action against an individual insurer or seek orders to have a term in such contracts declared unfair.

However, in the absence of consistent UCT laws across all financial products and services, ASIC would have to produce separate guidance and adapt its enforcement mechanisms specifically to the insurance context. ASIC will administer UCT for insurance contracts in line with its current responsibilities in respect of UCT and the IC Act. Compared to Option C, ASIC's costs would be higher for these reasons, and reflecting the differences between insurance and other financial products and services. For example, ASIC may have to take additional court action specifically against the insurance industry to obtain a separate ruling on a term otherwise deemed unfair in another industry.

Insurance brokers and agents might also expect that contracts will have been reviewed for fairness by the insurers, particularly brokers who are expected to represent the interests of consumers. They will also benefit from additional certainty in the regulatory regime.

However, these stakeholders may have some minor additional costs related to training and further understanding of insurance contracts that are revised as a result of UCT laws, although this is unlikely to be widespread. Adjustments are likely to be lower than under Option C reflecting tailoring to the existing insurance contract legislation.

5. IMPLEMENTATION ASPECT - RIGHT TO TAKE ACTION

5.1. OPTIONS

If UCT laws are applied to insurance contracts (Options C or D), one element that could be tailored to the insurance context is standing to take action against insurers for breach of UCT laws.

As noted above, one risk in applying UCT laws to insurance contracts is the additional uncertainty created due to the risk of challenges to clauses that limit or exclude liability. Insurers argue that, regardless of whether the challenges are ultimately successful, even the prospect of legal challenges would increase risk to the point that it could impact on the cost and availability of reinsurance, and impact on premiums.

Consequently, the 2011 draft RIS sought stakeholder views on whether potential uncertainty for insurers could be reduced by limiting the scope for individual policyholders to challenge terms on the grounds of unfairness.

A summary of the two options are as follows:

- Option I provides that only ASIC has the right to bring action against an insurer on the basis of unfair terms under the UCT laws – consumers would not have standing to bring an action in this instance; and

- Option II allows both ASIC and consumers to bring action against an insurer on the basis of unfair terms under the UCT laws.

Option I: ASIC only right to take action

Recognising concerns that the application of UCT laws could result in additional costs for insurers from frivolous litigation, particularly if Option C or D is implemented, Option I would seek to mitigate this risk by preventing individual policyholders from challenging terms on the grounds of unfairness. Instead, only ASIC would be permitted to challenge UCT in court.

Under this option, ASIC could accept complaints directly from the public. If ASIC assessed that a term was likely to be unfair, in the first instance it could approach the insurer(s) involved and seek to have the insurers cooperate to modify the term voluntarily.

In the event that the insurers involved did not agree, under the UCT laws, ASIC could apply to the court to seek orders declaring that a term was unfair, and orders for the benefit of affected consumers.

This option would provide additional protection for consumers from disadvantage or loss resulting from UCT through ASIC action and may be effective in reducing costs of litigation for insurers. However, it would reduce avenues of recourse for consumers and would be inconsistent with existing UCT laws.

Option II: ASIC and consumers right to take action

Option II would apply the existing approach of UCT laws under the ASIC Act, under which ASIC or any party to the contract can apply to a court to have a term declared unfair.

This option would provide additional protection for consumers from disadvantage or loss resulting from UCT by empowering consumers to take action against breaches of UCT laws.

5.2. IMPACT ANALYSIS

Option I: ASIC only right to take action

Impact on consumers

Option I would limit the rights of consumers who have suffered detriment as a result of UCT to take action against the insurer. To be clear, this Option would restrict all avenues of recourse to ASIC, meaning affected consumers would not be able to lodge a claim through FOS in the case of an alleged UCT.

As ASIC has limited resources to take legal action against alleged UCT, it would limit action to public interest cases of suspected widespread consumer detriment. This might adversely affect consumers in the 75-150 cases per annum estimated above who in practice might have no recourse to take FOS or court action against insurers. Consequently, consumer detriment would be expected to be close to that estimated under Option A above.

Consumers who have suffered detriment as a result of UCT would be expected to benefit from the application of UCT laws relative to the status quo, reflecting the aforementioned public interest cases pursued by ASIC. These consumers would also benefit from ASIC using its new powers to negotiate with insurers and encourage them to address individual cases of consumer detriment. However, ASIC

would have no legal basis to itself exclude the terms and would only rarely take further action if unsuccessful in negotiating an outcome with the insurer.

Impact on insurers

Option I would reduce instances of potential litigation against insurers (and therefore the potential litigation costs).

Insurers would also benefit from ASIC applying a centralised approach to UCT disputes, which would provide greater certainty in adjusting insurance contracts to remove terms determined by courts to be unfair.

Impact on other stakeholders

There would be a limited number of court cases upon which ASIC can take action against insurers which would impose greater pressure and expectation on ASIC to pursue individual cases. This may cause it difficulty in effectively managing individual consumer issues.

This would be expected to involve lower costs for courts, as there would be fewer cases brought before them.

Option II: ASIC and consumers right to take action

Impact on consumers

Option II would deliver all of the benefits of Option I resulting from ASIC's powers to take action for those consumers who have suffered detriment as a result of UCT..

In addition, Option II would enable these consumers to take action in the cases where they believe it is necessary. This provides an additional layer of protection for these consumers against possible detriment and mitigates the costs to consumers described in Option I.

Option II would also provide consumers who have suffered detriment as a result of UCT with equivalent protection to that provided under existing UCT laws. However, Option II may result in additional litigation costs, and uncertainty, for insurers compared to Option I that would ultimately be of detriment to these consumers to the extent that such costs impact the price and availability of insurance. In consultation of the 2011 draft RIS, the insurance industry did not provide quantitative evidence of the impact of different options for who would have the right to take action. It is arguable, however, that if insurers act reasonably and conservatively in assessing its standard form contracts, it is less likely they will be subject to challenge, therefore reducing costs that would otherwise be passed onto the consumer.

Impact on insurers

Option II has the potential to involve additional litigation costs for insurers, although as noted under Option I, these are likely to be rare and can be mitigated by insurers in most cases.

Option II would involve greater uncertainty and risks for insurers resulting from consumers taking frivolous action against unfair terms.

Impact on other stakeholders

ASIC would benefit from being able to apply a consistent approach to litigation and broader enforcement in respect of all UCT laws. ASIC's costs could be marginally lower if it can rely on individual consumers to undertake test cases against contract terms it is concerned with. As noted previously, ASIC will administer UCT for insurance contracts in line with its current responsibilities in respect of UCT and the IC Act.

Courts might expect to judge additional, rare cases under Option II.

6. IMPLEMENTATION ASPECT – MAIN SUBJECT MATTER

6.1 OPTIONS

If UCT laws are applied to insurance contracts (Options C or D), one element that could be tailored to the insurance context is the scope of 'main subject matter'. As noted above, the definition of 'main subject matter' is a significant consideration in determining the scope of contracts to which UCT laws will apply, and therefore the effective implementation of UCT laws.

To be clear, this (and all other options) would also adopt the 'upfront price' and 'term required, or expressly permitted, by a law of the Commonwealth or a State or Territory' provisions of the ASIC Act, whereby such terms are also exempt from UCT laws. The latter of these exemptions would capture the standard cover provisions of the IC Regulations.

This section assesses the effectiveness of a range of options for defining the 'main subject matter' of insurance contracts and the impacts of these options on affected stakeholders. A summary of the options are as follows:

- Option 1 maintains an exemption from the UCT laws for the main subject matter of the contract – this option provides a broad definition of 'main subject matter' which would exempt from consideration under the UCT laws terms that define or circumscribe the insured risk and the insurer's liability under the contract;

- Option 2 maintains an exemption from the UCT laws for the main subject matter of the contract and adopts the same approach that currently exists for other financial products under the ASIC Act - that is, the common law approach is adopted for the definition of 'main subject matter' and is for a court to interpret its meaning and application;

- Option 3 maintains an exemption from the UCT laws for the main subject matter of the contract – this option provides a narrow definition which would exempt from consideration terms that describe the class of insurance being purchased by the consumer, for example, 'comprehensive motor vehicle insurance' or 'home and contents insurance'.

- Option 4 differs to existing UCT laws by providing no exemption from the UCT laws for terms that fall under the main subject matter of the contract – this would allow all terms to be subject to UCT laws (except for terms describe the upfront price or that are permitted or prescribed by law).

Option 1 - Broad legislative definition of 'main subject matter'

Option 1 would prescribe in legislation a broad definition of 'main subject matter' for UCT laws in insurance contracts based on the European Commission Directive 93/13/EEC on Unfair Terms in Consumer Contracts.

Legislation would define 'main subject matter' as with reference to the underwriting risk that the insurer takes on under the insurance contract. There are various other ways this could be applied in legislation, such as the current EC Directive terminology ('a term that *defines or circumscribes the insured*

risk and the insurer's liability under the contract of insurance') or by reference to terms taken into account by the insurer in the calculation of the premium.[31]

This option provides a broad exemption for any contract terms that relate to risk or liability, for example, capturing any exclusions and limitations that relate to the liability. As mentioned above, exemptions will also be provided for terms that set the upfront price payable under the contract and terms in the contract that are required or expressly permitted by law.

While interpretation of the various broad approaches is somewhat uncertain, experience with the EC directive suggests a significant number of disputed terms would be exempt as 'main subject matter'. The UK regulator has only taken action against unfair terms that are clearly unrelated to the risk defined by the policy. For example, the UK courts have interpreted a travel insurance policy exclusion for personal liability caused by motorised watercraft as part of 'main subject matter'. The UK regulator has only sought undertakings from insurers in relation to 'main subject matter' terms where they are not in plain and intelligible language, and in these cases the insurer simply had to improve the clarity of the term (that is, the term could remain unfair so long as it was in plain and intelligible language).

Under this option, it is likely that a limited number of terms would be subject to UCT laws and be those that relate to the 'small print' aspects of the contract, including terms that affect:

- the right to unilaterally vary the contract;
- the right to terminate the contract;
- discretion to exercise contractual powers;
- the right to transfer its obligations under the contract; and
- terms that are not in plain and intelligible language.

Option 2 – Likely narrow common law interpretation of 'main subject matter'

Option 2 would apply the existing ASIC Act approach which adopts a common law interpretation of 'main subject matter'. This approach provides for the courts to establish the scope of main subject matter. Option 2 would therefore provide a consistent approach to main subject matter across all financial products and services. As mentioned above, exemptions will also be provided for terms that set the upfront price payable under the contract and terms in the contract that are required or expressly permitted by law.

While the interpretation of the courts is somewhat uncertain, evidence from Australian common law (as discussed above) suggests that the 'main subject matter' of an insurance contract could be interpreted quite narrowly. That is, the 'main subject matter' of the contract could be 'the essence of the deal' that the consumer has entered into and not necessarily the scope of the insurance cover. The 'main subject matter' could be defined as, for example, comprehensive motor vehicle insurance or home and contents insurance for a particular property. However, without precedent it is difficult to say how a court will interpret 'main subject matter' in the context of insurance contracts.

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[31] The Irish Law Reform Commission, in its *Consultation Paper on Insurance Contracts*, January 2012, recommends an amendment to the application of the EC Directive so that the exemption for main subject matter is defined as those 'terms that have been considered by the insurer in the calculation of the premium'.

If 'main subject matter' was to be interpreted narrowly by the courts, the majority of terms in an insurance contract would be subject to UCT laws (other than those covered by the exclusions for up front price or prescribed terms) including exclusions and limitations in the contract. It would enable ASIC and consumers to take action on such terms.

However, there is uncertainty with respect to the interpretation of the ASIC Act definition of 'main subject matter', and a broader interpretation could reduce the scope of terms UCT laws would apply to.

ASIC is likely to provide guidance on UCT laws, including the interpretation of 'main subject matter' and in the longer term would be expected to reflect the outcomes of any court decisions on these matters.

Option 3 – Narrow legislative definition of 'main subject matter'

Option 3 reflects an approach recommendation by consumer groups which would prescribe in legislation a narrow definition of 'main subject matter' as the terms that describe the class of insurance cover, for example, 'comprehensive motor vehicle insurance', 'home and contents insurance' and 'travel insurance'. It is expected that, if Option 2 were adopted, a court would interpret 'main subject matter' in this way, that is, the 'essence of the deal' being entered into. This would make all terms subject to the UCT laws, except terms that describe the class of cover, and as mentioned above, the upfront price and terms prescribed or expressly permitted by law.).

If this option were implemented, the court would also be given direction to have regard to a number of factors in determining whether a term is unfair. Other factors may include, for example:

- the contract as a whole;
- the appropriateness of utilising other remedies in the IC Act to the dispute;
- the insurer's compliance with the IC Act in relation to the contract that is the subject of the dispute;
- whether the term reasonably reflects the underwriting risk accepted by the insurer; and
- the manner in which, and the extent to which, the contract is or has been carried out.

Option 4 – No exemption for 'main subject matter'

Option 3 would mirror the approach of the Nordic and several other European countries by not providing an exemption for 'main subject matter' in relation to insurance contracts. By being explicit about not exempting 'main subject matter' from UCT, Option 4 goes further than Options 2 and 3 in allowing ASIC and consumers to challenge any unfair terms without having to rely on a court interpretation of 'main subject matter'.

This option would still include the exclusions from UCT laws for terms that set the upfront price and terms that are required or expressly permitted by law. This option would make all other terms of insurance contracts subject to UCT irrespective of whether they are central to the risk and pricing of the arrangement between the insurer and consumer. This would enable ASIC and consumers to take action against any instance of unfair terms in relation to an insurance contract.

6.2 IMPACT ANALYSIS

Option 1 - Broad legislative definition of 'main subject matter'

Impact on consumers

Option 1 would be expected to deliver some of the potential benefits of applying UCT laws to insurance contracts to consumers who have suffered actual or potential detriment as a result of UCT. In particular, Option 1 would require insurers to assess the fairness of the 'small print' of their insurance contracts or risk them being voided by the courts. Option 1 would also enable ASIC to seek undertakings from insurers to remove terms it considers unfair and provide additional recourse for consumers to take action against UCT that are not exempt as a term which is the 'main subject matter'.

The extent to which Option 1 would deliver the potential benefits of introducing UCT laws depends on the interpretation of the definition by the courts. While this is somewhat uncertain, experience with the EC directive suggests a significant number of disputed terms would be exempt as 'main subject matter'.

If such an interpretation were applied in Australia it would limit the number of disputes that could be brought under the UCT laws. By way of context, an assessment of the FOS cases (identified above in the RIS) indicates that all but 6 disputed claims involving an exclusion or limitation relate to terms that would likely be considered as 'main subject matter' under this definition and could be expected to be reduce the potential benefits to 12-24 cases or $810,000-$1.62 million in dispute. In addition, the risk of detriment to remaining consumers is not expected to be significantly reduced.

This would reduce the protection to affected consumers offered by UCT with respect to terms that are exclusions and limitations.

As noted in the next section, insurers could be confident that the contract terms that are likely to have the most impact on pricing would be exempt from UCT laws. This would reduce the cost to insurers of adapting to UCT laws and minimise any consequential changes to the pricing of insurance (premiums) and the availability of cover for consumers.

Impact on insurers

Option 1 would protect insurers from the potential costs and uncertainty resulting from UCT laws applying to core aspects of insurance contracts. It would provide insurers with more certainty in prescribing the risk they are willing to accept for that level of premium.

Insurers are also likely to benefit from lower costs of adapting to UCT laws that are more limited in scope. This is in terms of both the upfront cost of reviewing the legality of contracts and the potential costs of FOS or court action against individual insurers. While it is difficult to estimate the cost of Option 1, and this has not been provided by key stakeholders, it is supported by the insurance industry who has stated that it would mitigate the potential costs of introducing UCT laws.

Impact on other stakeholders

ASIC's additional powers to take action against UCT would be limited by the 'main subject matter' exemption. As this exemption could be interpreted quite broadly, ASIC may be limited in its ability to take action against the majority of unfair terms.

Option 2 – Likely narrow common law interpretation of 'main subject matter'

Impact on consumers

If 'main subject matter' is interpreted narrowly, Option 2 would maximise the potential benefits for consumers resulting from reduced detriment (whether actual or potential) of UCT in insurance.

These consumers may also benefit from the additional security of knowing that they and ASIC have additional recourse to take action against insurers who include unfair terms in contracts. In turn, this lowers the risk to consumers of entering into an insurance contract.

However, this option may increase the cost and reduce the availability of insurance cover to the extent it resulted in the additional risk and uncertainty for insurers of having the majority of contract terms subject to a test of fairness. While the exact reduction in benefits is difficult to quantify in the absence of sufficient evidence being provided by stakeholders, costs to insurers are expected to have a small but potentially meaningful impact on consumer benefit (for those who suffer actual or potential detriment) from UCT laws.

However, it is possible that courts could interpret 'main subject matter' more broadly which will have a similar impact as Option 1.

In any case, it is arguable that insurers, in reassessing standard contract terms, will act reasonably and conservatively to reduce the likelihood of a challenge, therefore reducing costs that would otherwise be passed onto the consumer. It is also arguable that standard contract terms that generally favour the insurer (in order to limit their liability) are reasonably necessary to protect their legitimate interests. Therefore, the ongoing costs of reinsurance could be mitigated by taking a reasonable and conservative approach in assessing standard contract terms. In addition, ASIC is likely to issue guidance for insurers on unfair contract terms, including on how to interpret 'main subject matter', and in the longer term would be expected to reflect the outcomes of any court decisions on these matters. At least in the long term, ASIC guidance will assist in reducing potential uncertainty and mitigate associated costs. Insurers may also engage with ASIC to provide discussions on the interpretation and application of UCT laws.

Impact on insurers

If interpreted narrowly, Option 2 may involve increased costs for insurers (as also outlined in the impact on consumers). Arguably however, insurers may mitigate these costs by acting conservatively, referring to ASIC guidance and engaging in discussions with ASIC when reassessing their standard contract terms. UCT laws will not mean that insurers would not be able to rely on limitations and exclusions in the contract but rather how such terms are prescribed (such as obligations they might impose on the insured). This could ultimately assist in reducing the cost impact on insurers and their reinsurance arrangements, and in reducing the cost impact on consumers.

However, if the courts interpret 'main subject matter' more broadly, the impact of this option for insurers would be similar to that described for Option 1.

Impact on other stakeholders

Under this option, it is expected that ASIC would have a broad ability to take action against UCT in insurance. However, ASIC would still face some initial uncertainty regarding the interpretation of 'main subject matter' as the scope of this exemption is tested in the courts. Over time, it is expected that ASIC could confidently take action against any unfair policy exclusion or limitation without being significantly limited by the 'main subject matter' exemption.

This option would provide a consistent approach to defining and interpreting 'main subject matter' in UCT laws for all financial products and services. This will allow ASIC to administer UCT for insurance contracts consistently with those for other financial products and services, which should result in administrative efficiencies.

Option 3 – Narrow legislative definition of 'main subject matter'

Impact on consumers

The impact on consumers would be largely the same as Option 2 if 'main subject matter' was interpreted narrowly by the courts.

A specific definition and direction to the court to consider certain factors when determining whether a term is unfair, such as whether more appropriate remedies in the IC Act are available, will reduce insurer's uncertainty and costs and therefore, any costs passed onto consumers will be lower compared with Option 2.

Impact on insurers

In the long term, the legal costs that insurers would incur under this option would be similar to Option 2 if 'main subject matter' was interpreted narrowly by the courts. In the short term, legal costs are likely to be lower than Option 2 as there would be more certainty on what is included as main subject matter which in turn would reduce the number of test cases to determine its definition. Other costs to insurers, such as reinsurance, are also likely to be lower than Option 2 as it will be clear which terms will be subject to review under UCT laws.

In addition, a court will be given direction to consider a number of factors in determining whether a term is unfair. These factors will allow a court to, amongst other factors, consider alternative remedies under the IC Act, allow the consideration of the insurer's underwriting of the risk they accept under the contract, and the insurer's compliance with the Act as a whole in relation to the contract subject to the dispute. This will provide additional certainty to insurers as it will ensure that such factors are considered in determining whether a term is unfair.

Impact on other stakeholders

The impact on ASIC would be similar to Option 2 if 'main subject matter' were interpreted narrowly, however, ASIC will have more certainty about which terms are subject to review under UCT laws. While this provides an alternative approach for main subject matter under UCT laws as compared with other financial products, any difference in overall cost on ASIC is likely to be marginal given this option reflects how a court is likely to interpret 'main subject matter' in the ASIC Act.

Option 4 – No exemption for 'main subject matter'

Impact on consumers

The benefits and costs of Option 4 would be more extensive than other Options as there would be no exemption for main subject matter.

UCT laws would be expected to have a more immediate impact under Option 3 because ASIC would be able to take action against all unfair terms in insurance contracts without first testing the legal interpretation of 'main subject matter'.

To the extent that consumers who suffer detriment would no longer have to prove in court that a term is not excluded by 'main subject matter', this option may involve slightly lower legal costs.

Impact on insurers

Under Option 4, the risk of challenge may be higher as effectively all contract terms would be subject to UCT laws (other than those required or relating to price). Again, it is arguable that insurers will act conservatively when preparing standard form contracts to reduce this risk and therefore would reduce the costs associated. The upfront cost of adjusting to UCT laws would be the same as under Options 2 and 3.

Impact on other stakeholders

ASIC would be able to take action for UCT in insurance to the greatest degree possible. ASIC would benefit from not having to test the interpretation of 'main subject matter' exemption in the courts.

ASIC would administer UCT for insurance contracts in line with its current responsibilities in respect of UCT and the IC Act, which would have the administrative efficiencies noted with respect to Option 2.

7. CONSULTATION

Extensive consultation has been undertaken on the application of UCT laws to insurance contracts. Most recently (December 2011), Treasury released a draft RIS seeking stakeholder views on the above options for applying UCT laws to insurance contracts. Treasury received 11 submissions in response to the draft RIS and has further consulted with ASIC and interested key stakeholders in the preparation of this RIS.

Submissions in response to the 2011 draft RIS illustrated continuing disagreement between key stakeholders on the extent and impact of unfair terms in insurance contracts and the best overarching approach for addressing any problems.

Insurers and their representatives continued to dispute the existence of unfair terms and argue the existing regulatory regime provides appropriate safeguards for consumers (they support maintaining the status quo – Option A). One exception in the context of life insurance was BT, which supported a restricted inclusion of UCT laws into the IC Act (modified Option D).

In its supplementary submission to Treasury, the Insurance Council of Australia noted that out of Options C and D, it supported Option D because it:

- Would minimise regulatory inconsistency in relation to 'consumer contract' under the IC and ASIC Acts;
- Would minimise regulatory uncertainty and enable tailoring of examples to the insurance context; and
- Avoids unwanted consequences of repealing or amending section 15 of the IC Act, which provides broader relief from State and Territory legislation.

Consumer representatives and FOS support UCT laws applying to insurance contracts.

The Consumer Action Law Centre expressed strong support for Option C, noting the legal benefits of ensuring consistency between UCT laws. Other consumer advocates were indifferent between the legislative mechanisms for introducing UCT laws.

Submissions in response to the 2011 draft RIS illustrate significant disagreement with regard to both the interpretation and proposed scope of 'main subject matter' with respect to insurance contracts.

Consumer Action Law Centre (CALC) does not believe it is necessary to clarify the meaning of 'main subject matter', as courts do not find it difficult to determine this under current UCT laws and interpretation in respect of insurance would be similarly narrow. Similarly, Legal Aid NSW notes that common law has traditionally defined the 'main subject matter' of an insurance contract in quite narrow and precise terms. These stakeholders generally support a narrow definition or interpretation of 'main subject matter' that ensures this definition does not limit the application of UCT laws to key contract terms including policy exclusions (Option 2 or 3).

The ICA submitted that any application of UCT laws to insurance contracts must clarify that the 'main subject matter' excludes from review terms and exclusions that define an insurance contract's scope of cover. These stakeholders argue that if UCT laws were to apply, a broad definition of 'main subject matter' is necessary and should largely replicate international experience.

In a supplementary submission following further discussions with Treasury, the ICA proposed that 'main subject matter' be defined to exempt any term that '*defines or circumscribes the insured risk and the insurer's liability under the contract of insurance*' (Option 1).

Following public consultation on the draft RIS, Treasury has consulted closely with key stakeholders on options for 'main subject matter'. Insurance industry stakeholders continue to prefer Option 1 to all other options and consumer representatives continue to prefer Option 2.

Consumer advocates, FOS and insurance brokers strongly support allowing consumers the right to take action, achieved by applying the existing UCT laws to insurance contracts.

While submissions from the insurance industry generally argued that consumer rights should be limited (meaning that ASIC only should have the right to take action), it was clear that this alternative approach would not address insurers' key concerns with UCT laws and 'main subject matter'.

For example, the ICA submission noted that:

> *'although restricting exercise of remedies to ASIC has a superficial attraction, it still exposes an insurer's scope of cover terms to review and potential voiding. The insurer will be obliged to take account of and price for this risk regardless of who can exercise the remedies.'*

More broadly, limiting consumers' rights to take action is a quite separate issue to the scope of 'main subject matter'. 'Main subject matter' provides an exemption from UCT laws for specific terms in a contract, whereas limiting the right to take action reduces the broader avenues of recourse for consumers against all contract terms covered by UCT laws. The issue of the right to take action is being considered as part of this RIS separate from the definition of 'main subject matter'. Stakeholder comments regarding the 'Problem' or 'Impacts' are incorporated in these sections.

UCT laws in insurance more broadly have been the subject of extensive consultation prior to the draft RIS process. A brief summary of this consultation is as follows:

2004 – Review of Insurance Contract Act 1984

The issue of unfair terms in insurance contracts and, in particular, whether section 15 of the IC Act needed to be retained, was considered as part of the second stage of the review of the IC Act in 2004. Submissions to that review were 'starkly divided on the ongoing need for section 15 with strongly held views being expressed both in favour and against its retention'.

Those against its retention argued that:

- insurance contracts are not so different from all other contracts that they should be immune from the general law regarding unfair contracts;

- the duty of utmost good faith in sections 13 and 14 has not been sufficient to encourage insurers to act fairly in drafting policies and enforcing their terms; and

- the provisions in sections 13 and 14 and the dispute resolution bodies interpreting them can only assist individual consumers — they cannot address systemic issues and indications are that there are systemic problems with unfair terms in insurance contracts.

Those in favour of its retention unaltered argued that:

- insurance contracts are not 'immune' from general consumer protection avenues — rather they are dealt with under specific legislation which takes account of the complexities of insurance contracts and the fact that liability is reinsured, often on an overseas market, and re-insurers will not necessarily be bound by Australian judicial review;

- insureds have adequate protection arising from the duty of utmost good faith in sections 13 and 14 and although the use of those provisions has been limited, the response should be to encourage their use, not make available a multitude of other remedies;

- external dispute resolution bodies provide a low cost and speedy means of resolving disputes in the insurance contracts framework — it is undesirable to encourage use of litigation.

The Review Panel concluded that the consequences of repealing section 15 were too uncertain to warrant taking that step. However, the arguments were finely balanced, and if a nationally consistent model for review of consumer unfair contracts were developed, the balance of consideration may shift and the issue should be revisited.

2009 – Inquiry by Senate Economics and Legislation Committee

The consideration of the same issue in 2009 in the context of the inquiry by the Senate Economics and Legislation Committee into the Trade Practices Amendment (Australian Consumer Law) Bill, including the Committee's conclusion, is described in the 'Background' section of this RIS.

2010 – Options Paper

In March 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, introduced the Insurance Contracts Amendment Bill 2010 (ICA Bill) into the Parliament. While the Bill did not deal with unfair contract terms, Minister Bowen released a paper to coincide with Bill, which sought comments on options to address unfair terms included in insurance contracts. The paper described five possible options to deal with the potential for unfair terms in insurance contracts:

- status quo;

- permit the UCT provisions of the ASIC Act to apply to insurance contracts;

- extend IC Act remedies to include tailored UCT provisions;

- enhance existing IC Act remedies; and

- encourage industry self-regulation to better prevent use of unfair terms by insurers.

A number of comprehensive submissions were received from stakeholder groups in response to the paper. The options most favoured were the status quo (supported by the insurance industry) and permitting the UCT provisions of the ASIC Act to apply (supported by consumer representatives). The other options were generally not supported, although some stakeholders considered one or more of those could be 'second best' solutions if their preferred option were not adopted. Copies of the submissions on the March 2010 options paper are available at http://www.icareview.treasury.gov.au/content/insurance_options_submissions.asp?NavID=23.

2011 – Roundtable discussion of key stakeholders

Having regard to significant differences in views among stakeholders expressed in response to the 2010 Options Paper and at other meetings, in March 2011 the current Assistant Treasurer, the Hon David Bradbury MP, convened a roundtable of key stakeholders for the purpose of exchanging views on:

- arguments regarding the extension of UCT laws to insurance;
- how the 'main subject matter' exemption in UCT laws would operate in an insurance context; and
- other options with broadly comparable policy objectives, which could be considered independently of extending UCT laws, in particular:
  - strengthen pre-contractual disclosure requirements – to reduce the risk insureds are surprised by unexpected policy terms;
  - clarify the statutory formulation of the duty of utmost good faith to expressly recognise fairness as an element;
  - industry self-regulation of unfair contract terms – to provide a mechanism for terms causing concern to be addressed by insurers voluntarily; and
  - community education directed at insurance-related issues.

Although no consensus was reached between insurer and consumer representatives in relation to many of the questions raised, a further option emerged that the parties considered might produce a solution that satisfactorily addressed the key concerns of both sides. The idea was that the UCT laws could be applied to insurance contracts, however only the regulator would have standing to bring actions, rather than individual consumers.

2011 – Draft Regulatory Impact Statement

In December 2011, a draft RIS was released for consultation in order to canvas with stakeholders alternative options for addressing UCT in insurance contracts. The options explored in the draft RIS were:

- the overarching approaches in Options A to D in this RIS with an additional option of industry self-regulation;
- a broad versus narrow definition of 'main subject matter'; and
- if a narrow definition for 'main subject matter' was provided, only the regulator has standing to bring an action under UCT laws.

A number of submissions were received from stakeholders in response to the draft RIS. This was followed by discussions with stakeholders on the different options, particularly on the definition of 'main subject matter'.

Further discussions continued in that latter part of 2012. A number of alternative options were discussed with stakeholders. A key option recommended by consumer groups is reflected in the additional tailoring under Option D, the narrow definition of 'main subject matter' under Option 3 and that the court be directed to consider a list of factors which are tailored to the IC Act and insurance contracts. This option was considered as part of a stakeholder roundtable that consisted of a number of consumer advocates, the Insurance Council of Australia (ICA), the Financial Services Council (FSC) and a number of the members of the ICA and FSC. Stakeholders generally agreed on a

principle-based level to this approach, but there were differing views on the appropriate definition of 'main subject matter'. On this issue:

- Consumer groups have a strong preference for Option 3.
  - They assess that, by leaving the broadest scope for consideration of terms under the UCT provisions, this would provide the most meaningful outcomes for consumers in terms the fairness of the terms in insurance contracts.
- ICA members have a strong preference for Option 1.
  - They assess that this provides more certainty for insurers and exposes to UCT provisions those contract terms that are not referenced to the underwriting risk that the insurer takes on under the contract.
- If the Government did not choose to implement Option 1, the ICA's second preference is that Option 2, the ASIC Act approach, be implemented. ICA's view is that while this would create uncertainty in the short-term, a court would likely take a practical approach in defining the 'main subject matter' for insurance contracts which would be adaptable to existing and future practices.
  - Under Option 2, consumer advocates are concerned that if a court were to interpret 'main subject matter' broadly, it would diminish the potential benefits to consumers and that a lack of resources compared to insurers would prevent consumers from pursuing cases to secure an alternative court interpretation.
- The FSC expressed a more general preference that the definition of 'main subject matter' be tailored to reflect insurance contracts, that it should be defined as broadly as possible. In addition, FSC seeks an alternative treatment of life insurance given the long term nature of life insurance contracts compared with general insurance contracts.

8. CONCLUSION AND RECOMMENDED OPTIONS

While there are conceptual reasons suggesting UCT could be causing detriment to insurance consumers, it is difficult to make a conclusive assessment of the problem on the basis of available evidence. Best estimates based on the limited available evidence suggest that a small number of consumers may be suffering a small aggregate financial detriment due to instances of UCT and the application of UCT laws could be beneficial in mitigating some of this detriment.

Given the relatively small nature of the problem and expected benefits, the expected cost of proposed options needs be low to justify regulatory intervention. While it is similarly difficult to make a conclusive assessment of the expected costs due to legal uncertainty and the absence of clear estimates provided by key stakeholders, best estimates suggest that the costs of the options considered in this RIS would be low, particularly if insurers take a reasonable and conservative assessment of their standard contract terms.

Overarching approach

Options A and B would indirectly address unfair contract terms for insurance. Both Options C and D are the most direct options to addressing the Government's objective of protecting consumers against unfair diminution of rights under contractual arrangements developed in the absence of genuine

negotiation and ensuring consumers have appropriate remedies when they suffer detriment as a result of UCT (to the small extent that this occurs).

On balance, it is recommended that Option D be implemented. As a result of tailoring of the UCT laws to the insurance context, Option D would impose lower costs on industry in transitioning to UCT laws as compared with Option C.

Right to take action

If Option C or D is adopted, it is recommended that Option II be implemented. Option II would allow ASIC and consumers the right to take action, providing a policy approach consistent with the protections provided under existing UCT laws. This would otherwise be denied under Option I.

Main subject matter

As Options C and D primarily provide remedies for consumers in relation to UCT, all options for main subject matter are technically feasible but not all options would effectively address the Government's objectives.

Option 1 limits to the greatest degree the application of the UCT laws by applying a broad definition of 'main subject matter'. It will provide only a marginal benefit to the cases that would otherwise potentially benefit from protections from UCT laws (as indicated in the impact analysis).

Options 2, 3 and 4 would provide the greatest benefits to consumers as it would provide the greatest scope of terms that would be subject to UCT laws.

It is not recommended that Option 4 be adopted as it would be inconsistent with the general approach of existing UCT laws (that is, to provide an exemption for main subject matter of the contract). It also leaves open the possibility of a term being declared unfair that goes to the 'essence of the deal' that would otherwise be exempt under the existing UCT laws.

If the Government is seeking to provide an approach to 'main subject matter' that is consistent with existing UCT laws and could be considered in the context of court precedent from the existing UCT laws, on balance, it is recommended that Option 2 be implemented. Option 2 will be consistent with existing practices but would provide some uncertainty in the short term for all stakeholders. In addition, there would be higher legal costs for stakeholders until courts provide precedent on the interpretation of 'main subject matter'. This approach, however, will allow for a court to adapt the interpretation of 'main subject matter' over time to ensure it is consistent with industry practices and the existing UCT laws. Over time, as precedent is established, stakeholders will have more certainty about the coverage of the UCT laws.

If the Government is seeking to provide a legislative definition of 'main subject matter', for the purposes of short term and long term certainty, on balance, it is recommended that Option 3 be implemented. This option will offer clarity on what terms are included in the main subject matter exemption and reduce the legal costs of insurers and consumers that would otherwise have resulted in order to 'test' the court's interpretation of 'main subject matter'. By exposing a greater proportion of an insurance contract to UCT laws, this option would provide the most meaningful outcomes for consumers in providing change to the fairness of the terms in standard insurance contracts. However, it will expose insurers to greater risk of challenge as there would be a small number of terms that would be exempt from review under UCT laws.

9. IMPLEMENTATION AND REVIEW

Should the recommended options be adopted, consultation will be undertaken on draft legislation and a reasonable transition period would be provided. Providing a transition period will defer some of the short-term benefits but would give time for insurers to review contract terms for potential unfairness, and allow insurers to adjust to the new laws with minimal cost and disruption. This will reduce the costs that could otherwise be passed onto consumers if there is a short time for insurers to transition to the new regime. The new laws would apply to all contracts entered into or renewed after the end of the transition period, as this captures the majority of insurance contracts while allowing sufficient time for industry to adjust. Most general insurance contracts are renewed annually (when the premium payment falls due), which is expected to result in most (if not all) general insurance contracts transitioning to the new laws. As life insurance contracts are not renewed annually and the majority are obtained by third parties through superannuation, life insurance contracts are expected to enter the UCT laws more gradually.

As noted above, the recommended options would be implemented through legislative changes to the IC Act. Further public consultation on any draft legislation implementing the recommendations is envisaged prior to introduction of the Bill into Parliament.

Consistent with existing UCT laws, ASIC would be the primary regulator for enforcing UCT laws in insurance and is likely provide regulatory guidance to assist insurers comply with their legal obligations. Ultimately the courts (not ASIC) would declare a term unfair.

The effectiveness of UCT laws in insurance will be monitored on an ongoing basis by Treasury and ASIC in consultation with key stakeholders, including FOS. Monitoring will include an assessment of the outcomes and data on UCT disputes brought before insurers, FOS and the courts. As court cases on existing UCT laws are rare (given the short time elapsed since their introduction), it is likely to take several years before there is sufficient evidence on which to base a comprehensive review of UCT laws in insurance. Consequently, a comprehensive assessment would be expected to take place five years from the date the laws come into effect unless evidence suggests a more urgent need to revisit the issue.

APPENDIX A

SUBDIVISION BA OF THE ASIC ACT

Section 12BF - Unfair terms of consumer contracts

(1) A term of a consumer contract is void if:

(a) the term is unfair; and

(b) the contract is a standard form contract ; and

(c) the contract is:

(i) a financial product; or

(ii) a contract for the supply, or possible supply, of services that are financial services.

(2) The contract continues to bind the parties if it is capable of operating without the unfair term.

(3) A ***consumer contract*** is a contract at least one of the parties to which is an individual whose acquisition of what is supplied under the contract is wholly or predominantly an acquisition for personal, domestic or household use or consumption.

Section 12BG - Meaning of unfair

(1) A term of a consumer contract referred to in subsection 12BF(1) is ***unfair*** if:

(a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and

(b) it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and

(c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

(2) In determining whether a term of a consumer contract is unfair under subsection (1), a court may take into account such matters as it thinks relevant, but must take into account the following:

(b) the extent to which the term is transparent;

(c) the contract as a whole.

(3) A term is ***transparent*** if the term is:

(a) expressed in reasonably plain language; and

(b) legible; and

(c) presented clearly; and

(d) readily available to any party affected by the term.

(4) For the purposes of paragraph (1)(b), a term of a consumer contract is presumed not to be reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term, unless that party proves otherwise.

Section 12BH - Examples of unfair terms

(1) Without limiting section 12BG, the following are examples of the kinds of terms of a consumer contract referred to in subsection 12BF(1) that may be unfair:

(a) a term that permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract;

(b) a term that permits, or has the effect of permitting, one party (but not another party) to terminate the contract;

(c) a term that penalises, or has the effect of penalising, one party (but not another party) for a breach or termination of the contract;

(d) a term that permits, or has the effect of permitting, one party (but not another party) to vary the terms of the contract;

(e) a term that permits, or has the effect of permitting, one party (but not another party) to renew or not renew the contract;

(f) a term that permits, or has the effect of permitting, one party to vary the upfront price payable under the contract without the right of another party to terminate the contract;

(g) a term that permits, or has the effect of permitting, one party unilaterally to vary financial services to be supplied under the contract;

(h) a term that permits, or has the effect of permitting, one party unilaterally to determine whether the contract has been breached or to interpret its meaning;

(i) a term that limits, or has the effect of limiting, one party's vicarious liability for its agents;

(j) a term that permits, or has the effect of permitting, one party to assign the contract to the detriment of another party without that other party's consent;

(k) a term that limits, or has the effect of limiting, one party's right to sue another party;

(l) a term that limits, or has the effect of limiting, the evidence one party can adduce in proceedings relating to the contract;

(m) a term that imposes, or has the effect of imposing, the evidential burden on one party in proceedings relating to the contract;

(n) a term of a kind, or a term that has an effect of a kind, prescribed by the regulations.

(2) Before the Governor-General makes a regulation for the purposes of paragraph (1)(n) prescribing a kind of term, or a kind of effect that a term has, the Minister must take into consideration:

(a) the detriment that a term of that kind would cause to consumers; and

(b) the impact on business generally of prescribing that kind of term or effect; and

(c) the public interest.

Section 12BI - Terms that define main subject matter of consumer contracts etc. are unaffected

(1) Section 12BF does not apply to a term of a consumer contract referred to in subsection (1) of that section to the extent that, but only to the extent that, the term:

(a) defines the main subject matter of the contract; or

(b) sets the upfront price payable under the contract; or

(c) is a term required, or expressly permitted, by a law of the Commonwealth or a State or Territory.

(2) The upfront price payable under a consumer contract referred to in subsection 12BF(1) is the consideration that:

(a) is provided, or is to be provided, for the supply under the contract; and

(b) is disclosed at or before the time the contract is entered into;

but does not include any other consideration that is contingent on the occurrence or non-occurrence of a particular event.

(3) To avoid doubt, if a consumer contract referred to in subsection 12BF(1) is a contract under which credit is provided or is to be provided, the consideration referred to in subsection (2) of this section includes the total amount of principal that is owed under the contract.

Section12BK - Standard form contracts

(1) If a party to a proceeding alleges that a contract is a standard form contract, it is presumed to be a standard form contract unless another party to the proceeding proves otherwise.

(2) In determining whether a contract is a standard form contract, a court may take into account such matters as it thinks relevant, but must take into account the following:

(a) whether one of the parties has all or most of the bargaining power relating to the transaction;

(b) whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties;

(c) whether another party was, in effect, required either to accept or reject the terms of the contract (other than the terms referred to in subsection 12BI(1)) in the form in which they were presented;

(d) whether another party was given an effective opportunity to negotiate the terms of the contract that were not the terms referred to in subsection 12BI(1);

(e) whether the terms of the contract (other than the terms referred to in subsection 12BI(1)) take into account the specific characteristics of another party or the particular transaction;

(f) any other matter prescribed by the regulations.

Section 12BL - Contracts to which this Part does not apply

This Part does not apply to a consumer contract that is the constitution of a company, managed investment scheme or other kind of body.

SECT 12BM - Contraventions of this Subdivision etc.

Conduct is not taken, for the purposes of this Act, to contravene this Subdivision (or this Division) merely because of subsection 12BF(1).