1 February 2016

Peter Saunders
First Assistant Secretary
Regulatory Reform Division
Department of Prime Minister and Cabinet

Dear Mr Saunders

REFORMS TO LIFE INSURANCE REMUNERATION – REGULATION IMPACT STATEMENT (RIS)

This letter certifies that ASIC Report 413 - Review of Retail Life Insurance Advice (ASIC Report), the Review of Retail Life Insurance Advice (Trowbridge Review), and the Financial System Inquiry Final Report (Murray Inquiry), together have involved a process and level of analysis equivalent to a final assessment Regulatory Impact Statement (RIS) as set out in the Australian Government Guide to Regulation March 2014 (the Guide).

The reports will support the introduction of the Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2016 (the Bill) in the autumn sitting of Parliament.

Overview

Under the Future of Financial Advice (FOFA) reforms, conflicted remuneration, such as commissions, was prohibited. Currently, Part 7.7A of the Corporations Act 2001 (Corporations Act) exempts commissions relating to life risk insurance advice from being considered conflicted remuneration. The Bill removes this exemption so that commissions paid in relation to life risk insurance advice are conflicted remuneration and are banned.

However, commissions which satisfy certain requirements will not be considered conflicted remuneration and will continue to be permitted. These requirements relate to maximum permissible upfront and ongoing commissions, as well as a minimum two-year period in which insurers must recover, or 'clawback', commissions in the event a policy lapses. ASIC will be given the power to create an instrument specifying the maximum permissible commissions and clawback amounts (ASIC Instrument).

Independent Reviews used for Self-Certification

Treasury considers that the matters that must be covered in a final assessment RIS have been addressed through three reports:

1. the ASIC Report (http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-413-review-of-retail-life-insurance-advice/);

2. the Trowbridge Report (http://www.fsc.org.au/downloads/file/MediaReleaseFile/FinalReport-ReviewofRetailLifeInsuranceAdvice-FinalCopy(CLEAN).pdf); and

3. the Murray Inquiry (http://fsi.gov.au/publications/final-report/),

as well as through substantive consultation with key stakeholders.

The reports examine the remuneration arrangements for life risk insurance advisers and make recommendations which are intended to reduce incentives for advisers to unnecessarily churn clients through products.

Addressing the RIS questions

Question 1 and 2 – the problem and why government action is needed

Various inquiries have identified that the current remuneration arrangements for life insurance present a misalignment of interests between advisers and consumers. High upfront commissions create an incentive for advisers to replace consumers' existing products unnecessarily, commonly known as 'churn.' In addition, an insurer will typically only clawback a commission from an adviser when a policy lapses in its first year. As a result, product lapse rates increase significantly from the second year of a policy.

The ASIC Review found unacceptable levels of poor quality advice and a strong correlation between high upfront commissions and poor consumer outcomes, including in situations where the recommendation was to switch products. ASIC found that 37 per cent of the advice reviewed failed to comply with the legal quality of advice standard in force at the time the advice was given.

Government intervention is justified because of the significant costs to individuals and the community that can result from poor information on the benefits and risks of financial services, including life insurance. The problems associated with remuneration arrangements that involve commissions in the financial services sector have been known for some time.

Question 3 and 4 – the policy options, and the costs and benefits of each option

The Murray Inquiry recommended the implementation of a 'level commission' structure, whereby the upfront commission is not greater than the ongoing commission. It did not determine the percentage amount of the level commission that should apply in the life insurance sector, taking the view that this should be left to the market and industry. An initial level commission is typically not high enough to cover the upfront costs of providing advice, but level commissions provide higher remuneration over time.

The Trowbridge Review recommended a remuneration model based on an initial advice payment of no more than 60 per cent of the first year's premium and level commissions of no more than 20 per cent of the premium. It also recommended a continuation of existing arrangements for clawback, reforms to Approved Product Lists (APLs) and Statements of Advice (SoAs), and the introduction of an industry Code of Practice.

The Trowbridge Review argued that if advisers did not receive an initial payment beyond the ongoing commission, there would be a substantial mismatch between initial advice costs and the initial payment to advisers. This could lead to large numbers of financial advisers ceasing to offer life insurance advice, with the diminished supply of advice likely to exacerbate the underinsurance problem in Australia.

The Trowbridge Review recommended setting initial advice payments at $1,200. This recommendation was intended to make a contribution to cost recovery for advisers, while falling short of full cost recovery, which was estimated at between about $1,500 and $3,500 per client. The overall effect of Trowbridge's recommendation was estimated to reduce aggregate costs of life insurance protection by between 5 per cent and 10 per cent.

Question 5 – who will be consulted and how?

The Murray Inquiry took initial submissions on the issues set out in its terms of reference and a second round of submissions in response to its Interim Report. In developing the Government's response, Treasury took submissions on the recommendations in the Final Report.

The Trowbridge Review received 137 submissions from the industry, consumers and other interested parties. Consultations were held with consumer groups, government agencies (ASIC, APRA and Treasury), individual advisers, Australian Financial Services Licensees and insurance company executives.

The Government and Treasury consulted on a regular basis with industry stakeholders throughout the policy development process. An industry led process resulted in the development of the final reform package. Following the release of the draft Bill for consultation on 3 December, the Government held two industry roundtables involving the Financial Services Council, the Association of Financial Advisers and Financial Planning Association. Consistent with the Australian Government Guide to Regulation, the public consultation on the Bill was for a period of 30 days.

Question 6 – what is the best option from those considered?

On 20 October 2015, as part of its response to the Murray Inquiry, the Government announced it would support the retail life insurance industry's proposed reforms as announced by the then Assistant Treasurer on 25 June 2015. Proposals on commissions and remuneration of advisers included:

- reduction in upfront commissions, going from a maximum upfront commission of 80 per cent of the first year premium from 1January 2016, to a maximum upfront commission of 60 per cent of the first year premium from 1July 2018. Ongoing commission will be 20 per cent from 1January 2016;
- clawback over three years to apply from 1January 2016; and
- a ban on other forms of conflicted remuneration consistent with the FOFA reforms from 1July 2016.

The Minister for Small Business and Assistant Treasurer announced the final reform package on 6 November 2015. This final package included a revised commencement date of 1July 2016, and a change to the clawback period from three to two years.

The regulatory costing for this reform package has been prepared, consistent with the Government's Regulatory Burden Measurement Framework. These costs of the package are summarised in Table 1, noting that the 2016 offsets for the chosen option will be found from within the Treasury portfolio.

Table 1: Regulatory burden and cost offset estimate table

Average annual regulatory costs (from business as usual)				
Change in costs ($million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$27.8	$0	$0	$27.8
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Treasury	-$27.8	$0	$0	$27.8
Are all new costs offset? Yes, costs are offset				
Total (Change in costs - Cost offset) ($million) = ($995.69 million)				

Note: Offsets will be found for 2016 from the Treasury portfolio.

Question 7 – how will you evaluate and implement your chosen option?

Implementing these reforms, which will commence on 1 July 2016, will be a joint effort between industry, ASIC and the Government. The Government will amend the Corporations Act to give ASIC the power to create a legislative instrument to set caps on commissions and implement clawback arrangements. Ultimately, the final form of ASIC's instrument will be a matter for ASIC, as the independent regulator.

The Financial Services Council will have responsibility for creating the Life Insurance Code of Practice. Similar to existing codes for Banking and General Insurance, the Code would set out best practice standards for insurers, including in relation to underwriting and claims management. This work is already underway.

An ASIC review of Statements of Advice will commence in the second half of 2016.

ASIC will conduct a review in 2018 to consider whether the new industry arrangements for life insurance advice have better aligned the interests of firms and consumers. If the 2018 review does not identify significant improvement, the Government will consider moving to mandate level commissions, as was recommended by the FSI. The Government will ensure that the industry develops appropriate lapse reporting data to provide clear evidence for this review and that ASIC works with industry to ensure strong integrity around the data.

Should the OBPR have any queries in relation to this matter please contact Kurt Hockey on (02) 6263 2028 or kurt.hockey@treasury.gov.au.

Yours sincerely

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Deputy Secretary
Markets Group