Australian Government
The Treasury

TSY/AU

Reforms to the sale of add-on insurance products

Proposal Paper

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Manager
Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

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Submissions process

Closing date for any submissions: 30 September 2019

Email	addoninsurance@treasury.gov.au
Mail	Manager Insurance Team Financial System Division The Treasury Langton Crescent PARKES ACT 2600
Enquiries	Manager, Insurance Team, Financial System Division
Phone	+61 2 6263 2111

The principles outlined in this paper are not yet law.

Executive summary

Add-on insurance products and associated sales practices have received widespread scrutiny from the Australian Securities and Investments Commission (ASIC), the Productivity Commission and most recently the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission). These reviews have identified issues in add-on insurance markets including pressure-selling, poor claims ratios and low levels of consumer engagement.

On 4 February 2019, the Government responded to recommendations by the Royal Commission and the Productivity Commission by agreeing to mandate an industry-wide deferred sales model for add-on insurance products. The Government tasked Treasury to develop an appropriate deferred sales model.[1]

The Government will be consulting on the implementation of all recommendations of the Royal Commission through exposure draft legislation. However, by exception, the Government is releasing this proposal paper to support the implementation of an industry-wide deferred sales model. This is for the following reasons.

First, there are no jurisdictions comparable to Australia that have an industry-wide deferred sales model for add-on insurance products. Second, the add-on insurance market is diverse and complex—encompassing at least 28 distinct product-lines which are sold through a range of distribution channels and vary widely in how well they are understood by consumers. Third, the stakeholders likely to be affected extend well beyond the financial sector, including frontline intermediaries such as travel agents, airlines and mobile phone retailers.

This paper outlines the Government's proposal for an industry-wide deferred sales model for add-on insurance products. In line with the Royal Commission recommendation the model will capture all add-on insurance products by default and minimise exemptions. Exemptions should only arise where there is strong quantitative evidence of product value and consumer understanding.

Any feedback on the proposed model should be provided by 30 September 2019 and should specifically address the request for feedback boxes. Feedback should be focussed on how the measure can best be implemented, not whether it should be implemented. Submissions not consistent with this will not be considered.

The Government intends to consult on and introduce legislation by 30 June 2020 to implement the model.

[1] 'Restoring trust in Australia's financial system' February 2019.

Background

The Royal Commission highlighted poor consumer outcomes arising from the sale of add-on insurance. These insights built upon previous work by ASIC on add-on insurance sold in car dealerships and the Productivity Commission inquiry ‘Competition in the Financial System’.[2]

To address these issues the Royal Commission recommended introducing an industry-wide deferred sales model for the sale of all add-on insurance products, except for policies of comprehensive motor insurance (Recommendation 4.3). The Government agreed to mandate deferred sales for add-on insurance products and has tasked Treasury to develop an appropriate deferred sales model.

There is currently no statutory requirement for the sale of add-on insurance products to be deferred. However, ASIC has consulted on a deferred sales model in the car yard intermediary market, while its broader review of consumer credit insurance (CCI) prompted industry groups to take steps to introduce a deferred sales model.

Pressure-selling

The Royal Commission highlighted that the sales process for add-on insurance inhibits informed consumer decision-making. This was due to the inherent complexity of insurance products, unfair sales tactics, and weak competition in add-on insurance markets.

Drawing on ASIC’s submission to the Royal Commission, the final report found that combining the sale of a motor vehicle, finance and add-on insurance restricts the capacity of consumers to make ‘rational [and] informed purchasing decisions’.[3] Unfair sales practices such as pressure-selling were also considered to inhibit consumers from assessing the suitability of add-on insurance sold in connection with vehicles or vehicle finance.

The final report also cited the Productivity Commission to emphasise that the problems evident in motor vehicle add-on insurance and CCI exist across other add-on insurance products.[4]

ASIC also found that perverse incentives contribute to the mis-selling of add-on insurance.[5]

Poor value for consumers

There is also strong evidence of add-on insurance representing poor value for consumers in terms of claims ratios. While these issues are linked to pressure-selling and commission-based sales methods they also indicate problems with product design and quality.

ASIC’s review of five add-on insurance products including guaranteed asset protection (GAP), loan termination and CCI reveals markedly low claims ratios. Across the five products reviewed over a three-year period, the gross amount returned to consumers in claims was less than nine cents for every dollar of premium paid ($144 million in claims compared to $1.6 billion in premiums). This

[2] Productivity Commission inquiry, ‘Competition in the Australian Financial System’, 2018, chapter 15, pp. 415-33.

[3] Royal Commission Final Report (2019): p. 289.

[4] Royal Commission Final Report (2019): p. 290.

[5] ASIC Report 492 (2016): A market that is failing consumers: The sale of add-on insurance through car dealers, p. 6.

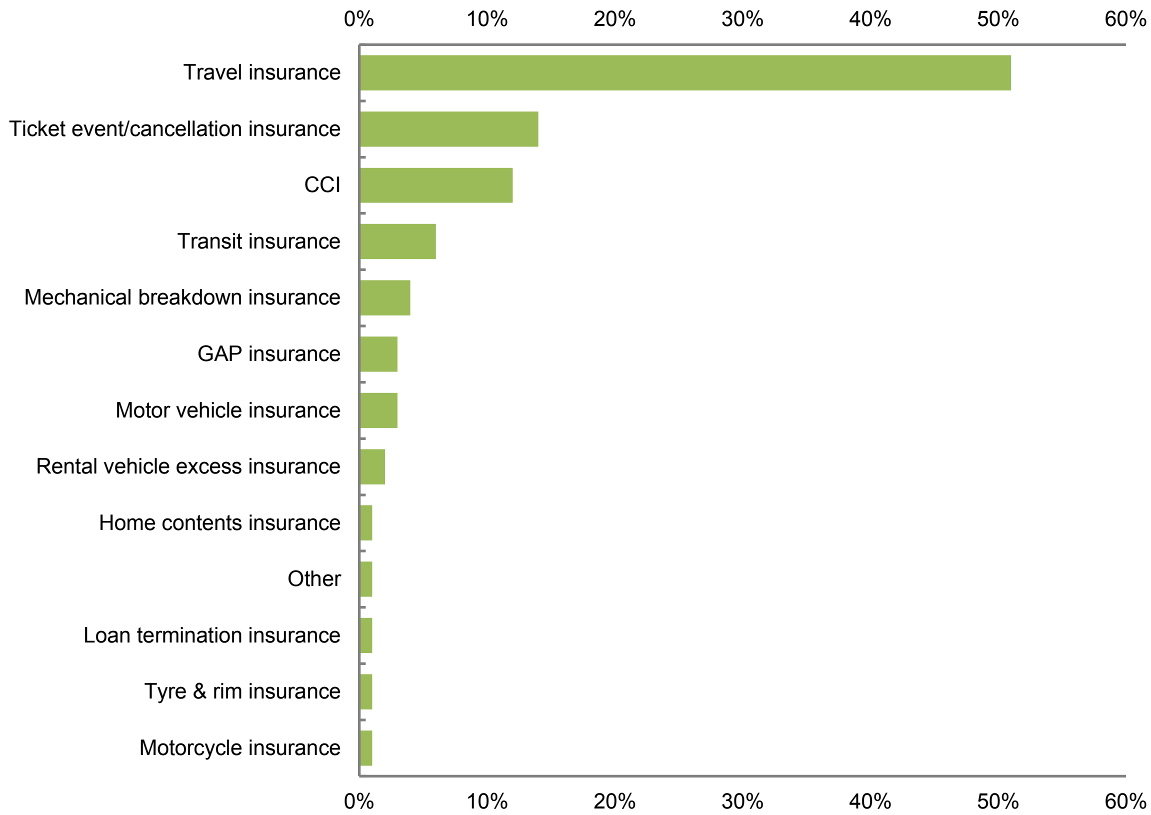
compares unfavourably against comprehensive car and home insurance which typically return more than 50 cents in the dollar.[6]

On 11 July, 2019 ASIC released a further review of CCI sales by eleven major banks and other lenders. The review found that the design and sale of CCI has consistently failed consumers, with only 19 cents returned in claims per dollar of premium paid. The review also uncovered widespread pressure-selling issues, accompanied by non-compliant personal advice, and consumers being sold CCI policies that they were ineligible to claim under.[7]

Weak competition and consumer disengagement

While the focus has been on car dealerships and CCI to date, the market is dominated by other products such as travel and ticket event/cancellation insurance (**Chart 1**).[8]

Chart 1: add-on insurance products by number of products sold[9]



The Productivity Commission and the General Insurance Code Governance Committee highlight that issues in add-on insurance markets derive directly from a sales method which is 'not confined to any single distribution channel'. [10]

[6] ASIC Report 492 (2016): A market that is failing consumers: The sale of add-on insurance through car dealers, p. 7.
[7] ASIC Report 622 (2019): Consumer credit insurance: Poor value products and harmful sales practices.
[8] General Insurance Code Governance Committee Report (2018): Who is Selling Insurance?, p. 5.
[9] General Insurance Code Governance Committee Report (2018): Who is Selling Insurance?.
[10] General Insurance Code Governance Committee Report (2018): Who is Selling Insurance?, p. 6. See also Productivity Commission (2018): Competition in the Australian Financial System.

While the most egregious instances of mis-selling and consumer detriment have occurred in relation to car dealerships and CCI add-on insurance, the sales method for add-on insurance products more generally can undermine consumers' ability to make informed and deliberate purchasing decisions. This is because the sales context restricts consumers' engagement with the insurance purchase and sellers are often under few or no obligations to ensure the product meets individual consumers' needs.

These findings are supported by data that suggests that insurance sold as an add-on insurance product often presents significantly less value than counterpart products sold in the standalone market (**Box 1** provides an example in travel insurance).

Box 1: The 'tick a box tax': Poor value add-on travel insurance

Choice found that airlines charge inflated premiums for insurance bought during the online ticket sales process. In its comparison of 30-day worldwide travel insurance policies sold during the booking process on Qantas, Virgin Australia and Jetstar international flights, the consumer group found that the cover represented poor value compared with standalone policies.

Issues raised included charging adult prices for children, who can be insured 'next to nothing' direct with an insurer.[11] Taking the example of a 30-day family trip to the US, Choice found that Qantas charged the adult amount for children aged 12 and older for a total cost of $1448. That compares with a similar $577 standalone policy from the same underwriter that is free for under-25s travelling with adults.

Commissions paid to intermediaries when they sell add-on travel insurance have been found to range between 35 and 65 per cent of gross written premiums.[12] These high commissions are undoubtedly contributing to driving the higher premiums of add-on travel insurance.

These findings point to inherent limitations in the personal suitability of travel insurance sold in conjunction with tickets or travel packages. While standalone markets offer opportunities to select cover that accurately reflects the risks associated with consumers' individual travel plans, travel insurance sold as an add-on is more likely to cover only generic events and could overlook more specific or unusual risks.

More broadly, the fact that add-on insurance is sold as an attachment or 'addendum' to a primary product or financing agreement means that consumer disengagement is a risk inherent to the sales process. Consumers tend not to 'actively seek' add-on insurance and are 'often more concerned with acquiring the credit card, loan or product to which it applies'.[13] For these reasons, consumers who are offered add-on insurance are generally not well-placed to assess policy benefits, limitations or personal suitability. Instead, these consumers are vulnerable to exaggerated claims of product value and are liable to exercise insufficient scrutiny of the product on offer.

The sales method for add-on insurance also insulates providers from normal competitive pressures. In a competitive market, consumers can exert competitive pressure on insurers by consulting a range

[11] Insurance News (2016): 'Don't buy airlines' travel insurance, says Choice', https://insurancenews.com.au/local/dont-buy-airlines-travel-insurance-says-choice; see also Choice (2016): 'Airline travel insurance vs buying direct', https://www.choice.com.au/travel/money/travel-insurance/articles/flight-travel-insurance.
[12] Finity (2019): General Insurance Distribution and Remuneration Arrangements ASIC, p. 6.
[13] Productivity Commission (2018): Competition in the Financial System, p. 418.

of different providers and selecting products on the basis of price and quality.[14] However, product retailers that provide add-on insurance benefit from a sales context that is characteristic of a 'situational monopoly', or an environment in which consumers are reliant on the information provided by one supplier and cannot 'shop around' to find the best deal. The Productivity Commission has also noted that some add-on insurance products are *only available* through a product retailer.[15] These features of add-on insurance markets show that competition does not effectively protect the consumer from overpaying or from purchasing unsuitable insurance products.

International experience

In 2015 the United Kingdom Financial Conduct Authority (FCA) implemented a deferred sales model for GAP insurance primarily sold in car dealerships. The FCA model mandates a deferral period of two clear days and is triggered by distributors issuing 'prescribed information' about GAP insurance to consumers. In addition, the FCA model enables consumers to initiate completion of the sale the day after the deferral period has commenced. The model targeted GAP insurance on the basis that it provided poor value for consumers (measured in claims ratios) and tended to be 'pressure-sold' through car dealerships.

In 2018 the FCA released an evaluation of its deferred sales model for GAP insurance. The evaluation found that the model had effectively reduced sales of GAP insurance through car dealerships and showed a marginal increase in standalone GAP sales. The evidence suggested that in the main 'consumers decide, on reflection, not to go ahead with the purchase'.[16]

However, neither the UK nor any other jurisdictions comparable to Australia have an industry-wide deferred sales model for add-on insurance products.

[14] Productivity Commission (2018): Competition in the Australian Financial System, pp. 86-87.
[15] Productivity Commission (2018): Competition in the Australian Financial System, pp. 415.
[16] Financial Conduct Authority (2018): Evaluation paper 18/1: An evaluation of our guaranteed asset protection insurance intervention, p. 3.

1. An industry-wide deferred sales model

The objective of the proposed deferred sales model is to promote informed purchasing decisions by consumers in add-on insurance markets. The model achieves this by introducing an enforced pause in the sales process between the purchase of a primary product and their decision to purchase add-on insurance. The deferral period will enable and encourage consumers to consider the merits of the insurance offered and to consult alternative providers.

The Government recognises the diversity of add-on insurance products available and acknowledges that different products cause varying degrees of consumer harm. That is why the Government proposes a 'graduated' deferred sales model of three tiers. Each tier will be regulated differently.

1.1 Scope of the deferred sales model

There is no existing statutory definition of 'add-on insurance', as the vast majority of products fall under the definition of 'general insurance' in the *Corporations Act 2001* (the Corporations Act). It is therefore important to clarify what add-on insurance is for the purposes of the proposed deferred sales model.[17]

Add-on insurance is predominantly sold by authorised representatives of insurers or other external sellers. Though insurers do directly sell some add-on insurance products through their own employees, the prevalence of representatives and external sellers in the market reflects that add-on is generally sold by a product retailer as 'additional' to a primary product or financing agreement.[18]

It is proposed for the deferred sales model to apply to those insurance products that are offered or sold *at the same time* as when a consumer purchases the primary product or acquires finance for which the insurance covers associated risks.

For example, pet insurance would only be subject to the deferred sales model in circumstances where it is offered at the same time or in conjunction with the purchase of the pet that it covers, or services provided in relation to the pet. Pet insurance sold on a standalone basis directly through an insurer would not be subject to the model.

Add-on insurance sold in a standalone market would remain outside the scope of the model, consistent with the Royal Commission recommendation. This would encourage consumers to consider and compare insurance offered in the standalone market, and to enable decision-making about insurance to occur outside of high-pressure sales environments.

The Government proposes to provide ASIC with the power to regulate risk management products similar to—though not technically the same—as add-on insurance. This would help to ensure competitive neutrality between AFSL-holders who issue risk management products.

[17] As a guide, the General Insurance Code Governance Committee found there were over twenty add-on insurance products currently sold. General Insurance Code Governance Committee Report (2018): Who is Selling Insurance?, Table 1

[18] The Government, in response to the Royal Commission recommendation 4.1, agreed the hawking of insurance products should be banned and that the definition of hawking will be clarified to include selling of a financial product during a meeting, call or other contact initiated to discuss an unrelated financial product.

1.2 Tier design

This paper proposes a tiered deferred sales model to ensure that add-on insurance products sold or offered at the same time as their associated primary products or financing agreements are automatically subject to a deferred sale (**Table 1** and **Figure 1** provides a summary).

A tiered approach provides flexibility, in light of the diversity of add-on insurance products available in the market.

Table 1: Tier summary

Tier	Description of add-on insurance product by tier	Proposed treatment under legislation
1	Products causing significant consumer detriment	ASIC Product Intervention Power
2	Default tier for all add-on insurance products (not in tiers one and three)	Legislated deferred sales model
3	Case-by-case exemptions for products that meet relevant criteria	Legislated ASIC exemptions power

Tier one

Tier one will be reserved for the most egregious add-on insurance products where there is evidence of significant consumer detriment (e.g. poor value for consumers in terms of claims ratios and widespread unfair sales practices). Given this, the most appropriate means of regulating these products will be through ASIC's existing product intervention power, recently legislated by the Government. The product intervention power would be used by ASIC if it were satisfied that the product has resulted, will result or is likely to result in significant consumer detriment.

This paper will not go into the details of the product intervention power.[19]

Tier two

Tier two will extend deferred sales requirements industry-wide and will apply on a default basis to all add-on insurance markets not covered by tier one. The design of tier two is outlined in the following sections of this proposal paper (**Figure 2** outlines the design of tier two).

Tier three

The Royal Commission stated that consultation should be undertaken to establish 'solid cases for exemptions' from the deferred sales model.[20] The final report also expressly recommended excluding policies of comprehensive motor insurance. The Government considers that is important to balance the benefits of deferring the sale of add-on insurance with consumer needs and preferences.

To achieve this, tier three will capture products which ASIC deems to be appropriate for an exemption from deferred sales requirements. This will protect consumers where the benefits of being able to purchase add-on insurance immediately outweigh the benefits of deferring the purchase.

The Government proposes the following criteria for tier three add-on insurance products:

- Historically good value for money;

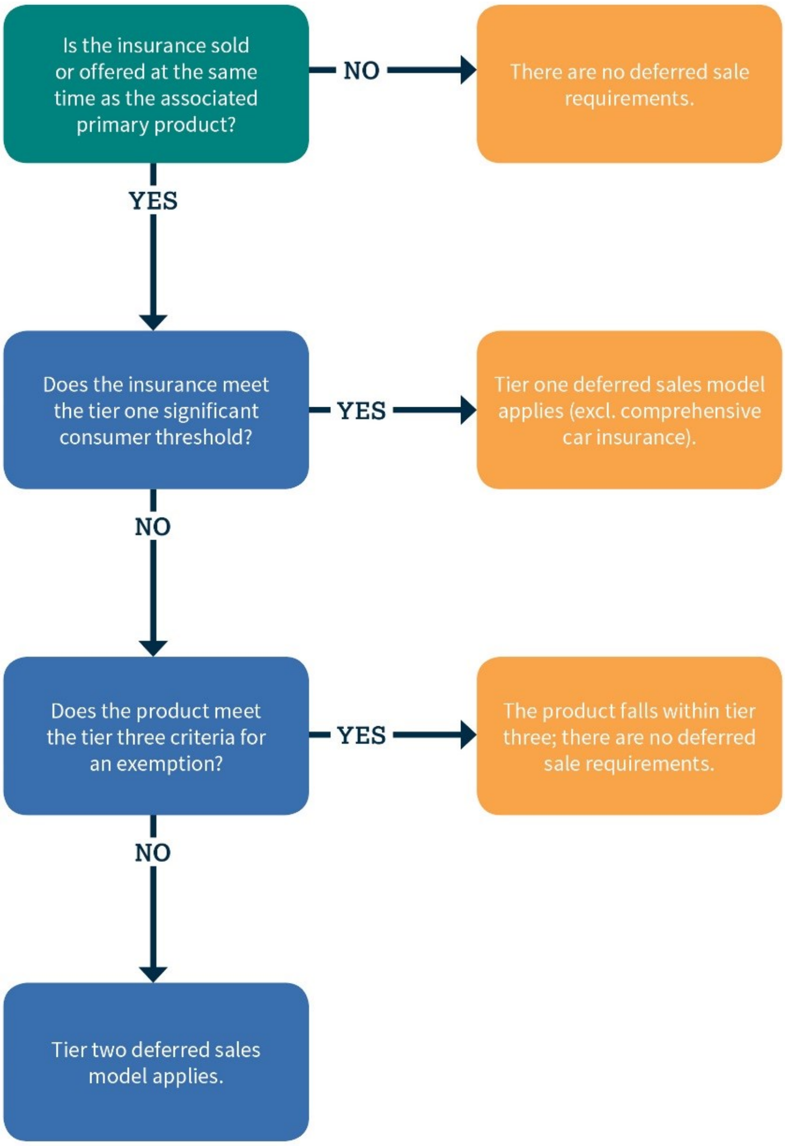
[19] See section 1023D(1)(b) *Corporations Act 2001*.
[20] Royal Commission Final Report (2019): p. 290.

- Strong competition;
- High risk of underinsurance;
- Well understood by consumers.

ASIC would have the power to include products in Tier 3 subject to conditions it specifies.

There are also other products that may need to be exempted from deferred sales requirements, such as add-on insurance required under law as a condition of the primary product purchase. The Government has also agreed to exempt policies of comprehensive car insurance, as recommended by the Royal Commission. The Government reserves the right to exempt these products from deferred sales requirements through primary legislation.

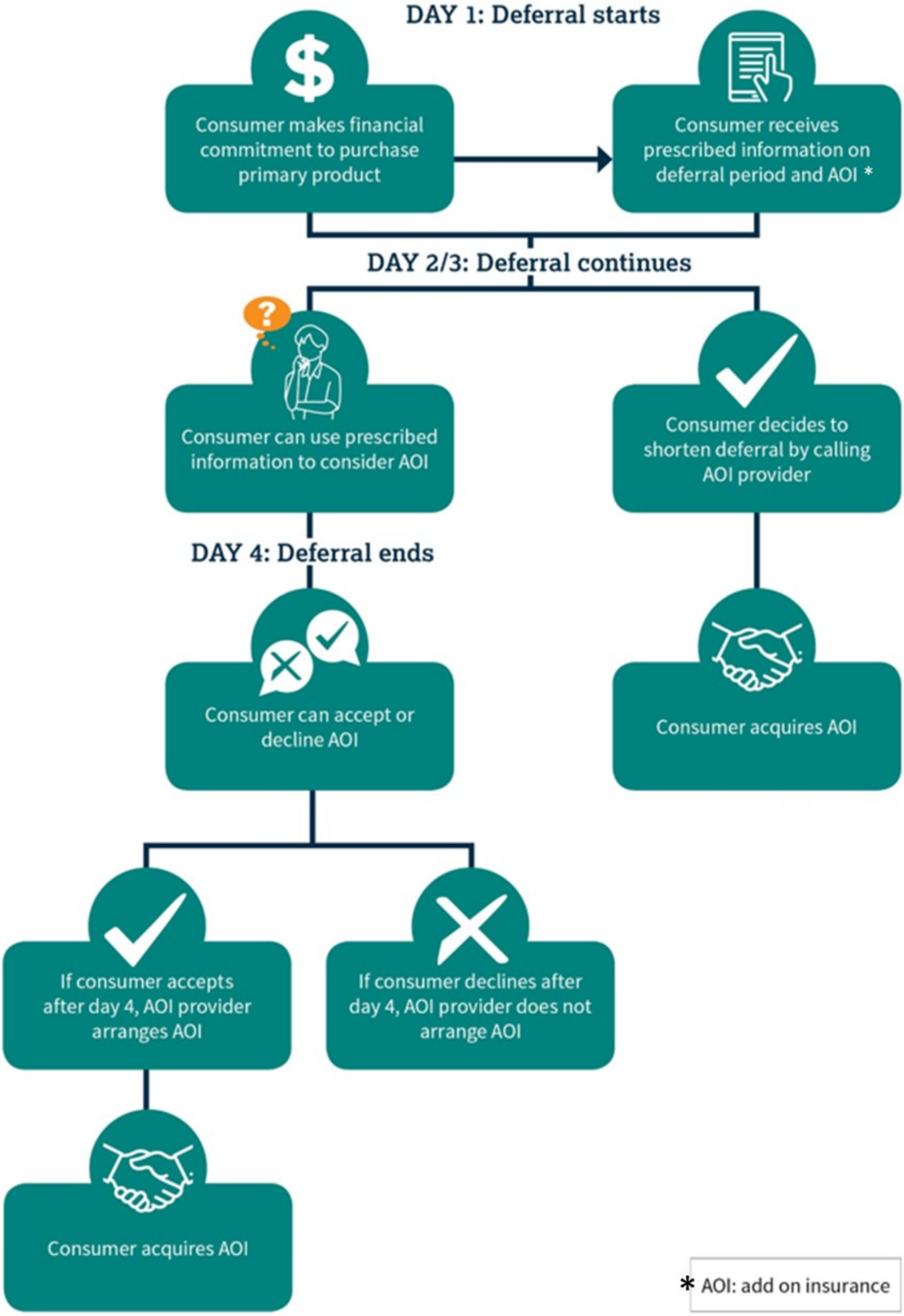
Figure 1: Overview of tiered deferred sales model



Request for feedback

Please provide evidence as to why a particular type of add-on insurance product should reside in a particular tier. This could include details of the sales process, claims ratios and distribution channels for different add-on insurance product lines. As per Commissioner Hayne's final report, exemptions should only arise where there is overwhelming quantitative evidence of product value and consumer understanding.

Figure 2: Tier two deferred sales model overview



1.3 Sales channel

The 'tier two' deferred sales model will operate neutrally across all sales channels, including intermediaries, external sellers, and online. This is because the issues identified by the Royal Commission stem from the nature of the add-on insurance sales process, which are common across distribution channels. The common features of add-on sales contexts are as follows:

- Add-on insurance products are sold alongside a primary product or financing agreement that captures the central attention of the consumer and receives their primary consideration in the sales process. This inhibits informed purchasing decisions about the add-on insurance product.
- Add-on insurance products are typically sold through intermediaries or external sellers[21] that are not subject to the strict licensing obligations and enforcement requirements that insurers operate under. Limited oversight and relatively weak sales conduct requirements increase the risk that add-on insurance is mis-sold to consumers.
- Add-on insurance products are usually (although not always) sold under a general advice model, in which the sellers are under no obligation to take into account personal financial circumstances of the consumer. This increases the risk that a consumer is sold insurance that does not meet their needs.

1.4 Trigger event

The trigger event determines when the deferral period will commence. Under the Government's proposal for the tier two deferred sales model, the deferral period is triggered by the two following steps taking place in the specified order:

> **Step 1**: The consumer makes a financial commitment to purchase the primary good/service and/or arranges finance.
>
> **Step 2**: The retailer provides prescribed information about the add-on insurance product – which includes details about the deferral period – following the financial commitment to purchase the primary product. A 'financial commitment' may involve paying a deposit or making an application for finance.

This trigger ensures that the deferral period commences only after the consumer has made a concrete decision to purchase or acquire the primary product. This limits the distraction that could arise from an incomplete decision about the primary product. This trigger is also documentable and easily verified due to the requirement for 'prescribed information' to be given to the consumer. The sequencing of the financial commitment and the prescribed information is designed to prevent the retailer from providing information to the consumer before the consumer has agreed to purchase the primary product.

Commencement of the deferral period could be before or after the consumer acquires the primary product or finance, depending on when this occurs relative to the trigger events.

Prescribed information will inform the consumer about key characteristics of the add-on insurance product on offer and details of the deferral period. This prescribed information should be provided to

[21] General Insurance Code Governance Committee Report (2018): Who is Selling Insurance?, p. 5.

the consumer if the retailer intends to sell add-on insurance to them, and in these cases, only after the consumer has made a financial commitment to purchase the primary product.

The Government proposes that the format, content and mode of delivery of the prescribed information be determined by ASIC, and could include:

- The total premium of the add-on insurance contract, including options for different cover levels within a particular product;
- The significant features and benefits, significant and unusual exclusions or limitations, and cross-references to the relevant policy document provisions;
- The duration of the policy;
- When the consumer can initiate completion of sale;
- The product claims ratio;
- Notification that the add-on insurance product is sold by other distributors
- A link to the ASIC MoneySmart website on the particular add-on insurance product (if available); and
- The date the above information is provided to the customer.

The prescribed information could be delivered via hard copy disclosure or online.

Request for feedback

Please provide feedback on how this trigger would correspond to your current business practices in selling add-on insurance products. This could include information on the number and frequency of customer touchpoints in the sales process and/or at what point in the process financial commitments are typically made by consumers.

1.5 Duration of deferred sale

The deferral period is an opportunity for the consumer to assess their needs and circumstances and consider the merits and suitability of the add-on insurance product. It should also mitigate the risk of consumers being pressure sold add-on insurance products.

As recommended by the Productivity Commission, an appropriate deferral length should be long enough to allow the 'halo effect' of purchasing the primary product or financing agreement to wear off so the consumer is able to dispassionately assess their need for insurance.[22] It should provide the consumer with an opportunity to consider alternative options and shop around. However, the deferral period should also not be so long that it would result in consumers disengaging entirely from the decision about whether to buy add-on insurance.

ASIC's consultation on a deferred sales model for add-on insurance sold in car dealerships highlighted that a deferral period shorter than four days would not provide a sufficient pause in the sales process, while a period longer than 30 days would likely be unnecessary. In comparison, the Productivity Commission considered a preferred minimum deferral period of seven days.[23]

[22] Productivity Commission (2018): Competition in the Financial System, p. 429.
[23] Productivity Commission (2018): Competition in the Financial System, p. 416.

We recognise that in certain circumstances, there is a risk of consumers not having insurance because they were unable to obtain an add-on insurance product in a timely manner. For instance, take the example of an individual that has purchased a plane ticket with an imminent departure time who would like to purchase the add-on travel insurance offered alongside their air fare. There is evidence that travel insurance sold through the standalone market is up to 30 per cent cheaper compared to similar add-on insurance products. The Government considers that the effect of imposing a deferral period in such circumstances would either: (1) divert the consumer to the standalone market which is likely to offer products of greater value; or (2) lead the consumer to opt out entirely from purchasing any travel insurance, leaving them underinsured. A four-day deferral period—in allowing the consumer to pause and evaluate their options—would limit the risk of the consumer being underinsured.

Taking these views into account, the Government proposes a deferral period of four days for the tier two deferred sales model.

At the conclusion of the deferral period, the Government proposes that the intermediary or the insurer will be able to contact the consumer via written correspondence, but only on one occasion. This is to ensure that the four day period does not simply defer the mis-selling that could otherwise have occurred at the time of sale.

1.6 Customer initiated completion of sale

The Government acknowledges that the deferred sales model may inconvenience some consumers and increase risks of underinsurance.

To deal with this, we will provide consumers with the flexibility to shorten the deferral period. This would allow engaged consumers to reduce the length of the deferral period to acquire the insurance earlier than provided for by the default model.

Specifically, the Government proposes that the sale of an add-on insurance product can be concluded the day after the deferral period has commenced if, and only if, the customer initiates completion of the sale. A customer initiating contact with the add-on distributor indicates engagement with the sales process and a deliberate purchasing decision.

Preserving the deferral period for a minimum of one day is necessary to prevent add-on distributors from compelling consumers to initiate the sale themselves immediately following the deferral period commencement, thereby compromising the policy objective.

This feature is consistent with the UK's deferred sales model for GAP insurance.

Further, the Government considers there could be an option for the consumer to reject the sale entirely during the deferral period.

1.7 Enforcement and when the deferred sales model will commence

ASIC will be responsible for monitoring and enforcing the regime to ensure that distributors are complying with the deferred sales regime. Criminal, civil and administrative penalties will be introduced for breaches of the deferred sales model.

The Government has committed to introducing the legislation to implement the deferred sales model by 30 June 2020.

The Government proposes providing a period of time between:

- the passage of legislation and
- the date when providers of tier two products will be expected to comply with the deferred sales model's requirements.

This time period would allow ASIC to assess applications for products to be exempt from the tier two deferred sales model—giving certainty to entities about which tier their add-on insurance product resides.