

INDUSTRY NEWS

Unfair Contracts Protections and Life Insurance

Treasury has recently concluded a consultation process with stakeholders in the general and life insurance industries about extending statutory remedies for unfair contract terms to insurance policies.

The draft model that Treasury has proposed will, if implemented, result in the current exception in *Insurance Contracts Act 1984* (the 'ICA') which prevent other legal remedies for unfair contract terms being applied to insurance contracts, as defined in the ICA, being abolished.

The *Australian Securities and Investments Corporation Act 2001* (the 'ASIC Act') will also be amended under the Treasury model to allow the terms of a life or general insurance policy that are declared to be unfair to be rendered void or to be subject of "other orders" which a court considers appropriate.

Treasury considers that only what it describes as "the main subject matter" of the contract and the "upfront price" will be exempted from scrutiny under the amended ASIC Act provisions.¹

If you think you have heard all this before, it is because laws regulating unfair contract terms ('UCT') were first introduced in relation to other consumer contracts some time ago and Treasury ran a consultation process with the insurance industry in 2012 with a view to applying them to insurance, which did not result in any changes being made at that time.

The decision to look at the issue again was instigated by the Senate Economics References Committee report but has been reinforced more recently by the recommendations of the Joint Parliamentary Committee on Corporations and Financial Services in its report in relation to the life industry released earlier this year² (the 'PJC Report').

Under the law that currently applies to consumer contracts outside the insurance industry³ a term of a consumer contract is unfair if it;

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

- is not reasonably necessary to protect the legitimate interests of the party advantaged by the term; and
- would cause financial or other detriment to a party if it were relied on.

In deciding if a term is unfair, a court is to take into account the whole of the contract and the extent to which the term in question is legible, presented clearly and expressed in plain language.

The major concern for the insurance industry in this proposed legislation is not that there are many provisions in policies that would fail this test. Aspects of the proposal are also clearly attractive to everyone, such as the incentive in the legislation to present products clearly and in plain language, which is obviously to everyone's benefit.

However, unlike other consumer contracts that are presently subject to UCT legislation, the distinction between what the contract is about – the core substance of the transaction and the terms on which it is provided, are less easily distinguished when someone purchases insurance, and essentially this issue underlies the industry's major concerns about the proposals.

The difference between the "main subject matter" of an insurance policy and other consumer contracts is well illustrated in the PJC Report, where it lists the kinds of terms that had been eliminated in the telecommunications, fitness and vehicle rental industries, as well as some contracts commonly used by online traders as a result of unfair contracts terms legislation⁴.

The eliminated terms all provided an illegitimate advantage to the service provider in relation to the way the contract could be changed or terminated by the service provider, or in relation to agents or the giving of guarantees. They have the common thread of being about how the provider could deal with the consumer over what they had purchased, but not over the essence of what the consumer had agreed to buy or what they agreed to pay for it.

Ironically, where there have been similar problems identified in the context of insurance, they have already been addressed and are part of existing legislative protections.

The insurance industry has pointed out in prior submissions to government that there are already significant safeguards for consumers built into the framework of the legislation it already works within, Government is clearly aware of this, and the consultation paper recently released by Treasury in June 2018 "Extending Unfair Contracts Terms Protections to Insurance" (the "Treasury model") examines them in some detail.

However, evidence of the bad outcomes some consumers have experienced which has been tabled at recent enquiries has clearly had an impact on the faith that regulators and legislators are willing to place in existing protections. This has shifted the argument in favour of the need to accept the case for universal consumer protections against unfair contract terms.

The critical question for the insurance industry has therefore ceased to be whether these changes are justified at all, and has turned instead into one about whether changes can be made in a way that prevents every declined claim turning into a legal dispute about the unfairness of the provision of the policy underpinning the insurer's decision not to pay.

A change which would provide a platform for arguments of this nature would undoubtedly be the worst outcome for all the stakeholders, generating uncertainty, rising levels of disputation, creating higher costs for everyone and possibly, in the long run, of significant prudential concerns.

Avoiding this outcome means convincing lawmakers about what the nature of the risk the insurer really underwrites in exchange for premium and the difference between this, which is the true "main subject matter" of an insurance contract and the incidental terms on which cover is provided.

This is not so simple a task as it may appear, when both sets of constructs are just words in a policy document which do not necessarily look that different to one another.

However, the point here is that some of these words contain the commercial core of the bargain into which neither party should want to introduce uncertainty⁵ and which ought to be regarded as the "main subject matter" while others are just the machinery that is supposed to facilitate the way the core bargain is delivered, and which should not be allowed to be unfair.

Fortunately, this issue is raised squarely for debate by the current treasury model.⁶

The model initially put forward by Treasury will only exempt specific features of insurance contracts from the UCT regime by exempting the "main subject matter" of a contract which in Treasury's preferred model "will be defined narrowly as terms that describe what is being insured, for example, a house, a person or a motor vehicle".⁷

According to the current Treasury model, all other provisions will be subject to the test of fairness and will be considered unfair unless "reasonably necessary to protect the legitimate interests of an insurer" which will be the case "if it reasonably reflects the underwriting risk accepted by the insurer in relation to the contract and it does not disproportionately or unreasonably disadvantage the insured."⁸

This is the wrong test to apply to provisions which define the boundaries of what the policy covers, which are at the heart of the commercial core of the bargain, because it would mean that every time it denied a claim an insurer would routinely have to establish that the premium it received was a fair reflection of the nature of the risk.

In other words, the narrow approach to what is the "main subject matter" produces an outcome which the Treasury model expressly says it will not permit, saying that "the 'upfront price' will include the premium and will not be subject to review".

The "narrow" view of the contract's subject matter would therefore mean that if it denies a claim, a life insurer might routinely have to prove in court that the contractual terms that describe what it is insuring, including general or specific underwriting exclusions, waiting periods and other conditions that describe when the cover commences or ends are a "reasonable reflection" of the underwriting risk that it accepted.

This looks exactly like the sort of approach which would lead to the proliferation of disputes that was identified earlier as the worst possible outcome for all the stakeholders (outside the legal industry of course) and, one which would generate higher levels of disputation, uncertainty, higher costs and ultimately, lead to prudential concerns.

Fortunately, there are other options canvassed in the current Treasury model which offer an alternative approach to the “main subject matter” based on the model developed in the European Union. This “exempts from the UCT regime terms which ‘clearly define or circumscribe the insured risk and the insurer’s liability.”⁹

The virtue of this approach is that it treats insurance contracts exactly the same way as the other contracts already regulated by UTC laws and preserves certainty over the essence of what the consumer has agreed to buy and what they agreed to pay for it.

So, what is a better description of the “main subject matter” of what a customer has agreed to buy when they purchase a life insurance policy? The answer is exactly what the EU model suggests, the promises that set out the insured risk and the insurer’s liability to pay the agreed benefit.

To enumerate this “main subject matter” in more detail, the customer has purchased a legally enforceable promise by the insurer to pay a benefit of particular type if a particular event occurs within a particular period. So the description of the benefit, the description of the insured event and when cover begins and ends are therefore integral parts of the “main subject matter”.

That is not quite all though.

Life policies are issued with conditions that the company’s actuaries must take into account in determining if the policy is prudentially acceptable at a given rate of premium, and the Prudential Standards require the Appointed Actuary to give written advice to the company in relation to this¹⁰.

Critical policy conditions will not just be the ones in relation to the description of the benefit, or the description of the insured event, but will also include provisions within the policy which have the effect of modifying either or both by, for example, excluding certain medical conditions (a general pre-existing conditions exclusion would be a typical example) or imposing a waiting period or other temporal exclusion calculated to defeat anti-selection.

The Appointed Actuary’s advice will also be premised on the assumption the company’s underwriters will only be permitted to issue cover within its underwriting guidelines, and also, more relevantly, that they may require other exclusions or conditions that are individually negotiated with the person applying for cover that render an otherwise unacceptable risk permissible within them.

The conditions and exclusions negotiated during the process of underwriting also modify the insured risk and the insurer’s liability to pay the agreed benefit. The sum total of these prudentially critical terms which describe the risk insured by the policy and define when the insurer is liable to pay truly form the “main subject matter” of a life policy.

Like other contracts currently covered by UCT laws, the core elements of the bargain with the customer represented by the “main subject matter” should not be rendered uncertain for either party under the new UTC laws by routinely requiring the insurer to prove they are reasonably necessary to protect its legitimate interests.

How broadly the “main subject matter” is defined in relation to life policies is one of the critical issues Treasury is seeking to resolve in the current consultation and exactly what solution is arrived at potentially has immense consequences for the future shape of the industry for life companies and customers alike.

However, it is only one of a number of issues that the industry needs to engage with. The Treasury model raises questions about the form the changes should take and to what extent they will apply to the group market which is characterised by bespoke policies negotiated by parties with equivalent bargaining power.

The closing date for submissions was 24 August 2018.

¹ To see Treasury’s summary of its proposed model, [click here](#). The changes will only apply a “consumer contract” or “small business” contract but the extent that either expression applies to group business is unclear.

² Report of the Parliamentary Joint Committee on Corporations and Financial Services in relation to Life Insurance, 28 March 2018. https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/LifeInsurance/Report

³ Meaning of Unfair - section 12BG the Australian Securities and Investments Commission Act 2001

⁴ PJC Report paragraph 3.26.

⁵ Or at least where uncertainty has established parameters under the ICA, such as policy conditions in relation to increased post-contractual risk affected by section 54 ICA.

⁶ Treasury model page 14.

⁷ Treasury model page 2.

⁸ Treasury model page 2.

⁹ Treasury model page 14.

¹⁰ LPG 320 Actuarial and related Matters. Paragraph 24.

BOX 1: SUMMARY OF THE PROPOSED MODEL

The proposed model seeks to ensure that insureds are provided with the same UCT protections already available to consumers in relation to other financial products and services, while ensuring the laws are appropriate in light of the specific features of insurance contracts.

It is proposed that the existing UCT regime in the ASIC Act apply to insurance contracts regulated by the IC Act. The key elements of the model are:

- Amending section 15 of the IC Act to allow the current UCT laws in the ASIC Act to apply to insurance contracts regulated by the IC Act.
- The UCT provisions in the ASIC Act being tailored in their application to contracts of insurance to accommodate specific features of these contracts, in particular:
 - the ‘main subject matter’ of an insurance contract will be defined narrowly as terms that describe what is being insured, for example, a house, a person or a motor vehicle;
 - clarification will be provided that the ‘upfront price’ will include the premium and the excess payable and that these will not be subject to review;
 - a contract will be considered as standard form even if the consumer or small business can choose from various options of policy coverage;
 - when determining whether a term is unfair, a term will be reasonably necessary to protect the legitimate interests of an insurer if it reasonably reflects the underwriting risk accepted by the insurer in relation to the contract and it does not disproportionately or unreasonably disadvantage the insured;
 - examples specific to insurance will be added to the list of examples of kinds of terms that may be unfair, which could include terms that permit the insurer to pay a claim based on the cost of repair or replacement that may be achieved by the insurer, but could not be reasonably achieved by the policyholder;
 - where a term is found to be unfair, as an alternative to the term being declared void, a court will be able to make other orders if it deems that more appropriate;
 - the definition of ‘consumer contract’ and ‘small business contract’ will include contracts that are expressed to be for the benefit of an individual or small business, but who are not a party to the contract;
 - for life policies, as defined by the *Life Insurance Act 1995*, which are guaranteed renewable, it will be made clear that a term which provides a life insurer with the ability to unilaterally increase premiums will not be considered unfair in circumstances in which the premium increase is within the limits and under the circumstances specified in the policy.