

M Harrison, D Trapnell – Trip Report

### **Background:**

The Australian Life Insurance market is subject to scrutiny as a result of four main factors:

- The “churn” debate
- The ASIC review into life insurance
- The Financial System Inquiry
- The Trowbridge Report

Following the release of The Trowbridge Report Michael Harrison and Don Trapnell decided to learn more about the situation in other countries, especially the United Kingdom, which had an industry review following the release of UK Consultation Paper 121 (Reforming Polarisation: Making the market work for consumers) in 2002.

In particular we sought information regarding the following questions:

- What can we learn from the UK regulation experience?
- How did the insurers respond?
- Were there any new innovations in distribution or products?
- Did any / many IFAs go out of business?
- How did IFAs respond?
- How do IFAs typically charge? Commission / Fees / Other?
- What new products do IFAs sell (if any)?
- How are IFA businesses typically structured?
- Is there an insurance “churn” issue?

We had the opportunity to meet with a number of industry personnel including life insurance company executives, IFAs, regulators and industry association members.

### **The UK Experience**

It is evident that there is a great deal of misconception in relation to the UK market. Before arriving we believed that commissions on life insurance had been banned and then reinstated. This misconception partly arises from the terminology. In the UK ‘Life Insurance’ is the term used for investment products – bonds and annuities; and ‘Life Protection’ is the term used for life insurance, as we know it in Australia.

The UK Government considered the submissions in relation to Consultation Paper (CP)121 and eventually banned commission on Life Insurance (investment) products but did not do so on Life Protection products. According to the Personal Finance Society (industry association) this was in recognition of the major underinsurance situation in the UK.

This is similar to the Australian situation. Rice Warner’s *Underinsurance in*

*Australia Report 2012* estimates the gap between cover held and cover required to maintain current living standards to be \$2.17 billion for death cover, \$7.91 billion for TPD and \$589 billion for income protection.

In fact commission payable on life protection products is higher in the UK than in Australia albeit with longer responsibility periods.

It was also evident in the UK that mis-selling related mainly to investment products (as has been the case in Australia).

The UK did however require higher education standards (but not to University Degree level), for advisers selling life protection products. This has resulted in a drop in adviser numbers and a significant drop in new sales. From 2003 to 2013 new life protection business halved in the UK from \$1.3 billion to \$650 million p.a. This decline is thought to be due to greater regulation and lack of point of sale innovation by the insurers (an issue we will be addressing later).

It is interesting to note that in Holland commission on life insurance was banned resulting in a 30% decline in Broker revenues from Life Insurance and a 33% drop in Broker numbers since 2012. Prior to the banning of commissions around 50% of Life Insurance product was sold by Brokers, to now less than 35% of all new business being sourced by Brokers. To compensate brokers in Holland must charge consumers fees.

The result has been an increasing protection gap, additional drain on Government resources and every non-Dutch international life insurance group leaving the market.

According to research consumer resistance in lower to middle class sectors has resulted in targeted Life Insurance sales occurring predominantly in the affluent sector with the under insurance gap in lower to middle classes increasing dramatically.

We had the opportunity of meeting with Matthew Browne (PWC) who was one of the team that implemented the Retail Distribution Review (RDR) in the UK. His comment was that the regulator was well aware that life insurance is a “grudge” purchase and, as such, was reluctant to do anything that would reduce sales even further.

A new study released by Europe Economics on the post implementation review of RDR, commissioned by the FCA, indicated that the cost of advice has risen in the UK since the RDR was implemented.

One view put to us is that some politicians believe “the UK regulator has a duty of care to the general public to ensure that they have appropriate advice available to them”.

### **The UK Life Protection Market**

In the UK a significant number of sales (said to be 60%-70%) are linked to home mortgages and most life protection advisers also sell mortgages.

However, the UK mortgage market is more regulated than in Australia with most mortgages needing to be repaid by age 65 or 70.

New rules in the UK also mean that lenders must carry out stricter checks on borrowers and have more responsibility for their actions.

The Mortgage Market Review was the attempt to clean up the home loans market after the easy credit boom of the 2000s. It has resulted in almost all mortgage sales now requiring advice and borrowers passing an “ability to pay” test. This is why there is a close link between mortgages and protection sales. This has resulted in the development of Life Protection products that match the mortgage term and expire at the same time as the mortgage.

We were initially puzzled as to why UK premiums appeared to be much lower than those in Australia, but after reviewing the mortgage linked products it is evident that policies have fixed terms (in line with the mortgage repayments) and as mortgages must be repaid by age 65 or 70, the policies are seldom in force when a claim event occurs.

As an example, the premiums on a Zurich £1,000,000 policy on a male aged 40 are:

Level term to age 65 - £114.50 per month, whereas a  
Whole of Life (equivalent to our term life) - £746.80 per month.

An equivalent policy in Australia with Zurich would cost £129.43 per month.

One firm employing over 250 telephone advisers explained how they “shape” products to perceived need – meaning that cover generally peaks when the children turn 21 and reduces thereafter. Again it means that premiums are much lower as the largest policy is unlikely to be in force (or needed) when a claim event occurs.

This particular (high profile) firm argued strongly that term insurance products are more closely aligned to general insurance products and should be treated as such. Advisers in UK are licenced to sell all life products and interchange sickness and accident policies with income protection when it is necessary to keep premiums down. In Australia selling sickness and accident policies requires a separate (General Insurance) licence and qualification. This is worthy consideration in Australia.

As stated earlier, commission payable on life protection products is higher than in Australia (although with longer responsibility periods). Generally policies have a four-year responsibility period (although advisers can reduce this to two years by accepting a lower rate of commission). Commission is paid monthly over 48 months (and advisers can opt for a discounted immediate payment), however the responsibility period remains. The discount rate appears to be up to 15%.

The UK market has some life protection specialists who sell income protection, critical illness and business insurance cover but these are less common. We met with some of these specialist protection advisers who sell large business

cases and they explained how they both ‘shape’ policies and offer clients a fee option equal to 75% of the commission and a net (no commission) premium as an option.

In the UK the commission free premium reduces the normal premiums by a staggering 40%, so much so that the client is in front in a couple of years. Interestingly that same practice has both business insurance and domestic insurance specialists. While the business insurance customers almost always accept the 40% discount off premium and pay a fee of 75% of the upfront commission (equal to around 135% of the first year premium as a fee), in the domestic market virtually no clients opt for the 40% discount and pay a fee, but opt to pay a higher premium and no fee.

It was interesting to learn that in South Africa the insurers acted independently to stop churn by establishing a central register of policy holders and agreeing between themselves that if a policy is replaced, the new commission is paid (on a five year pro-rata basis) to the old insurer. The new adviser only receives the pro-rata (remaining) amount of commission during the responsibility period.

In other words, the companies acted to eliminate churn, whereas in Australia the companies have declined to act and are seeking Government intervention to bypass the ACCC and do the job for them. (See FSC submission to Trowbridge.) This is said to be because no company wants to suffer a loss of business due to being a ‘first mover’.

Another solution would have been to introduce longer responsibility periods (as in the UK). This too has been rejected by Australian insurers.

## **The Future**

The Trowbridge review had promise but unfortunately the report has been largely discredited following the public release of the FSC submission to Trowbridge that is virtually mirrored in Trowbridge’s recommendations.

Instead of considering product innovation, Mr Trowbridge chose to focus on adviser remuneration and relied heavily on the conclusions drawn in the ASIC review.

Whilst the ASIC report may be statistically correct, our analysis suggests that the methodology utilised to arrive at the “fail” rate had unrealistic objectives.

It is worth restating that as part of this review

*“20 Synchron advisers and 40 files were reviewed. Four of our advisers and 7 files were found to ‘fail’ or be deficient (17.5%), however only two advisers had more than one deficient file.*

*One of those advisers had three deficient files and the other one had two. The adviser with three deficient files has had his Synchron authority revoked. ASIC also reviewed 15 files of two advisers whose authorities we had terminated 6 months before the files were provided to ASIC and for whom there were 4 failed files.*

*The other adviser, with two deficient files, was found to be deficient due to his clients being unwilling to provide personal financial information. This particular adviser works in an ethnic community that is reluctant to share information and where clients typically have large families and nominate the amount of cover that they require. He has since left Synchron.*

*The two advisers who had only one ‘failed’ file did not give bad advice; rather they omitted information from the SOA or client file.”*

In his report Mr Trowbridge states:

*“The catalyst for this report was the ASIC Review of Retail Life Insurance Advice of October 2014 which criticised quality of advice and misaligned financial incentives.*

*In its Review of Retail Life Insurance Advice released in October 2014, ASIC expressed concerns about high lapse rates in life insurance and the quality of advice being given by some financial advisers.*

*Life insurance is a very important financial product for our community. It protects Australians against disastrous financial outcomes when people unexpectedly die, sustain a serious illness or accident, or lose their ability to earn income. Yet underinsurance in Australia remains at very high levels.*

*This report now delivers a package of reforms designed to place the consumer at the centre of what life insurers and advisers do. It is intended to –*

- *ensure there is trust and confidence in the retail life insurance market; □*
- *encourage consumers to seek personal life insurance advice, being the best way to purchase □ insurance if the advice is professional and effective; □*
- *achieve the aim of more Australians having appropriate levels of life insurance protection; □*
- *remove misaligned financial incentives being offered to advisers and licensees; □*
- *contribute to the sustainability of adviser businesses and a competitive life insurance industry; □*
- *encourage the industry continually to adapt and to become more efficient and productive.” □*

*“The Reform Model can be described as level commissions supplemented by an Initial Advice Payment available at a client’s first policy inception and then no more often than once every five years, where:*

- *the level commission is a maximum of 20% of premiums; □*
- *the Initial Advice Payment (IAP) is paid by the insurer to the adviser on a per client basis □ (usually the insured life); □*
- *the IAP is available to the adviser when a client first takes out a life insurance policy and then no more often than once every five years (the “five year rule”); and □*
- *the IAP is a maximum of \$1,200 or, for customers with annual premiums below \$2,000, no more than 60% of the first year’s premiums.*

□ *Setting the IAP at \$1,200 is intended to make a contribution to cost recovery for advisers while falling short of full cost recovery, which is variously estimated at between about \$1,500 and \$3,500 per client.*

*It is aimed at delivering a balance between acknowledging the initial costs of advisers and eliminating any behavioural doubt as to whether the client's interests are being placed ahead of the adviser's own interests.*

□ *The overall financial effect of this Reform Model has been estimated, through some preliminary actuarial work, to reduce aggregate costs of life insurance protection by between 5% and 10%."*

As stated earlier, in both the UK and South Africa the companies acted to eliminate churn (which in turn eliminates the alleged nexus between high upfront commission and bad advice) by introducing longer responsibility periods, whereas in Australia the companies have declined to act and are seeking Government intervention or regulation, and blaming all the issues on the Advice channel.

We believe the Trowbridge objectives can be met by improved product design and smarter underwriting and we now intend to seek partners that are prepared to offer life insurance products that meet our specifications, in the same way that General Insurance Cluster Groups are successfully seeking underwriters to support their product design.

We are already negotiating to develop an Australian version of a highly successful electronic underwriting system that incorporates a simple point of sale assistant to assist with this process. Further information will be provided in due course.

The products will include a range of level premium fixed term products with a hybrid commission model, which, combined with the "advance" payment outlined below will ensure advisers are not dis-incentivised from providing advice to ordinary Australians.

As indicated above we will also seek to make arrangements whereby our advisers will be able to draw an advance on future commission earnings to enable them to recover the full cost of writing new business.

We support the concept of a Dealer Group fee (as recommended by Trowbridge) to offset the cost of compliance monitoring, education, professional development and other Dealer Group expenses however we believe it needs to be in the 3%-4% range. We also support the banning of "shelf-space" and other incentive payments.

We do not support the IAP (Initial Advice Payment) as it will be hard to administer and potentially open to abuse by the creation of multiple policy owners.

Based on our research the Trowbridge 'operating loss' proposal is counter-productive for two reasons:

1. It will be virtually impossible for new entrants to enter the business unless they become “tied” to the vertically integrated model as salaried advisers, thus reducing consumer choice.
2. A significant number of advisers will be forced to either exit the industry or reduce staff numbers (which is likely to impact on the standard of Adviser compliance).

We note that Trowbridge’s preliminary actuarial modeling indicates that premiums can fall by 5%. The insurance companies we have spoken to have actually indicated that premiums will probably increase due to the higher administration costs especially if the IAP is introduced.

Our proposed model will result in a longer responsibility periods and a reduced incentive to “churn” as level premiums will be difficult to replace. It will also result in the ability to ‘shape’ premiums to more accurately serve the needs of consumers. This will provide better cover when it is needed.

If we are successful finding underwriters (and early indications are that we will be), the objectives of Trowbridge and the FSI will be achieved, consumers will have greater choice and job losses will be unlikely.

**During the trip meetings were held with:**

David Thomas - Managing Partner, Chadney Bulgin (president Personal Finance Society)

Chris Gillies – Former Head of Distribution, Zurich Life UK

Roderic Rennison – Insurance Industry Consultant

Marcus Carlton – Exec Director, HFM Columbus (IFA & Asset Management Group)

Mark Waller – Compliance Director, HFM Columbus (IFA & Asset Management Group)

Adrian Emery – Global Distribution Manager, Aviva

Mark Sykes – Director, Sykes Ihlenfeldt Limited (IFA Group)

Craig Ihlenfeldt – Director, Sykes Ihlenfeldt Limited (IFA Group)

Nigel Herrick – Managing Partner, The Premier Partnership Ltd.

Martin Werth – CEO, Underwrite Me (Underwriting & Reinsurance)

Phil Jeynes – Head Sales and Marketing, Underwrite Me (Underwriting & Reinsurance)

Glen Sweet – Head of Sales, Transact (Platform Group)

Lee Clarke – Partner, Price Waterhouse Coopers (Head of Financial Services Group)

Steve Folkard – Director, Price Waterhouse Coopers (Financial Services)

Matthew Browne – Senior Manager, Price Waterhouse Coopers  
(formerly Financial Conduct Authority, Association of British Insurers)

Tom Baigrie, CEO at Baigrie Davies LifeSearch (IFA Group)

Richard Howells – Zurich UK (Head of Distribution)

Peter Hamilton – Zurich UK (Head of Product Proposition)

Richard Moodel – Zurich UK (National Account Manager)

Jon Round – Director, LSL Group (Property, Mortgages & Insurance)

Justin Taurog – MD, Vitality Life (South African owned Life Company)

Joe Jackson – Managing Partner, Spinitus Wealth (IFA Group)

Richard Martin-Redman – Managing Partner, Spinitus Wealth (IFA Group)