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finity

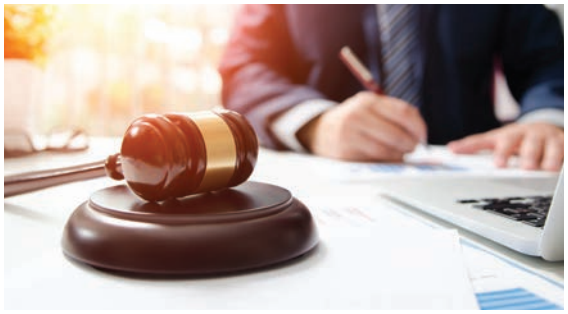
Regulatory compass: charting a way forward

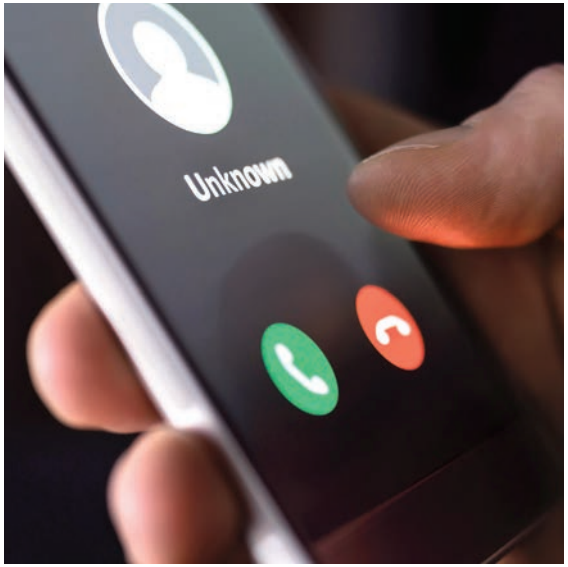
It's time to regroup and set our compass on all things regulation. Where were we up to? And where to from here? This feature article outlines the current state of play and what we think insurers need to be prioritising to chart their way forward. We also overview the key legislation that boards and management need to consider along the way.

Glossary of acronyms

- CFS – Claims as a Financial Services
- COP – General Insurance Code of Practice
- DDO – Design and Distribution Obligations
- DSM – Deferred Sales Model
- EDR – External Dispute Resolution (AFCA, unless otherwise stated)
- FAR – Financial Accountability Regime
- IDR – Internal Dispute Resolution
- PDS – Product Disclosure Statement
- PIP – ASIC's Product Intervention Power
- TMD – Target Market Determinations
- UCT – Unfair Contract Terms

This feature article was prepared in collaboration with our industry peers at The Fold Legal. The editorial team would like to acknowledge the time and research provided by The Fold, who help financial services and credit businesses manage their regulatory obligations.





Where to now on the regulatory roadmap?

- February 2019: The Treasurer announces the government will implement all 76 recommendations of the Financial Services Royal Commission
- February 2020: Consultation on 21 different draft changes to laws
- March 2020: COVID-19, for which 2020 will forever be remembered, puts a hold on activity
- October 2020: With the six month pause over, it is now time to regroup

Is the reform agenda still on track?

In the Optima 2018 publication (written in another era – before COVID-19, or 'BC'), we called out the 'regulatory turbulence' confronting Boards and the C-suite at the time.

Many in the industry, and other stakeholders, remain in a state of some confusion and uncertainty about what is or isn't 'hard law' just yet and where things may ultimately land. Insurers and other industry players want certainty; but partly due to the COVID-19 disruption, that certainty has not yet been delivered.

In our work with the industry on regulatory matters, we are often asked whether we think any of the slated reforms will be ditched and, if not, what the revised timing is. Despite the reset of priorities with COVID-19, we see no indications that government will abandon any of the changes.

After the six month pause, ASIC has come out with its latest Corporate Plan[1] which, in addition to addressing COVID-19 challenges, makes a clear statement of intent regarding other "important priorities and workstreams beyond our pandemic-related activities including:

- Deterring poor behaviour and misconduct through our 'Why not litigate?' discipline and driving cultural change using all of the regulatory tools;
- Improving entities' management of key risks to prevent and mitigate harms to consumers and promote a healthy financial system and economic growth;
- Reducing poor product design and restricting mis-selling;
- Reducing misconduct by company directors and professional service providers."

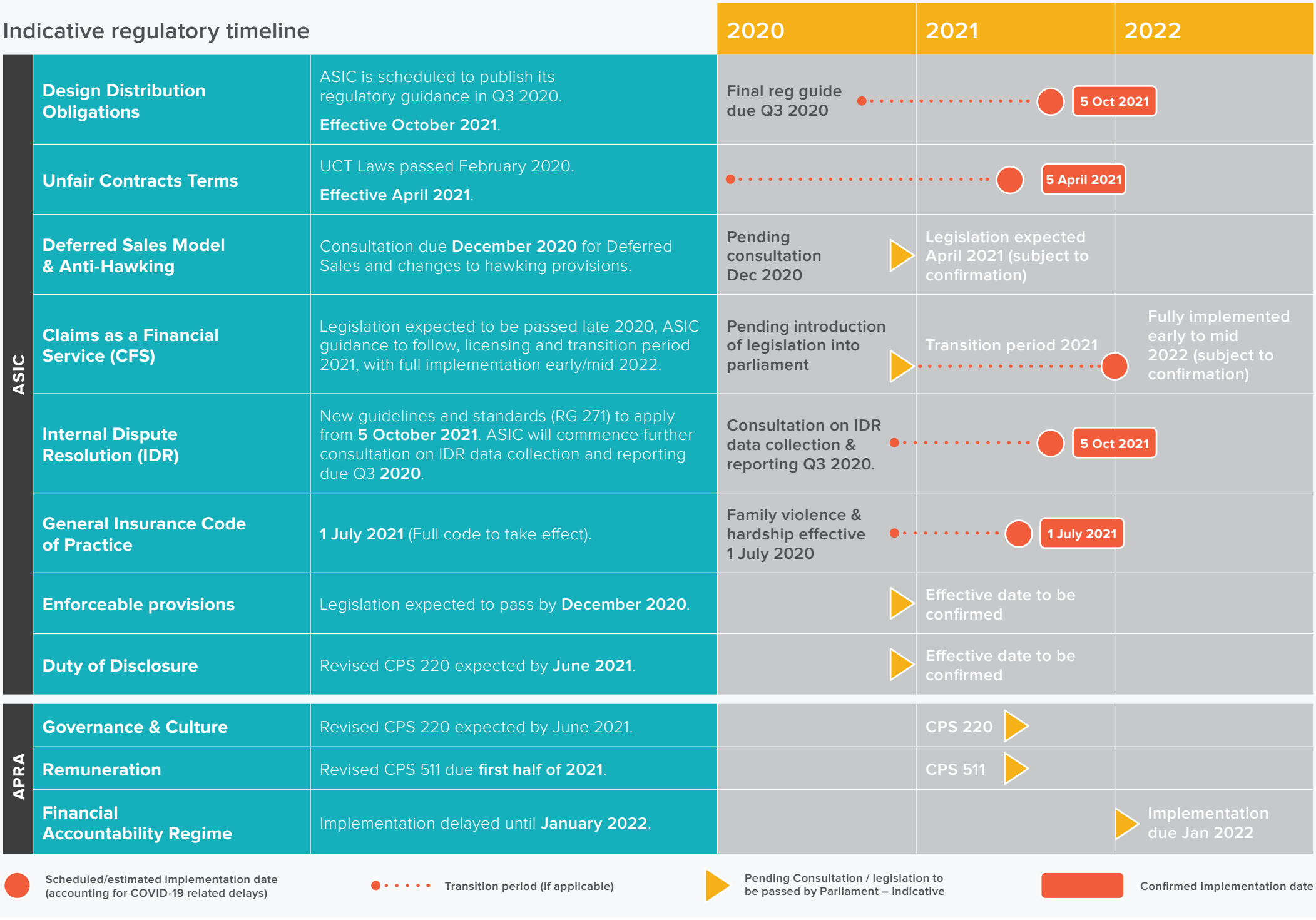
The current state of play

The key milestones and summary of progress are shown on the chart over the next page. Four of the changes have a confirmed effective date in 2021.

A number of the changes have the label 'legislation expected to go to parliament before end 2020'. As we write, there are enough sitting weeks for this to happen, but no announcements. We understand that the industry wrote to the Treasurer seeking a delay to implementation of the Royal Commission legislation to 1 July, 2022. To our knowledge there has been no formal response.

1 20-202MR ASIC's Corporate Plan 2020-24, 31 August 2020

Indicative regulatory timeline



What should you be doing?

We are often asked by our clients: “so what should we be doing right now?” Our answer usually starts with: “it depends on your current state”. Looking at the timetable, it is clear that insurers should be well advanced reviewing PDSs for potentially unfair provisions with the UCT legislation taking effect from 5 April 2021. Do your standard products have provisions that are unfair?

Product issuers and distributors should now be working steadily through their responses to the DDO and TMDs. We expect these to be relatively straightforward for ‘primary’ retail products such as home and motor, but more rigour will be required for products such as CCI, other add-ons, travel and personal accident. Anti-hawking and DSM work will likely involve changing processes and updating sales scripts and training.

Claims handling and dispute management (complaints, IDR and EDR) are the other areas of focus. In particular, vulnerable customer responses should have been prioritised. There is still a large amount of work to be done on Claims as a Financial Service. At this point we can call out the likelihood of major enhancements being needed for data collection with respect to claims, CFS, the General Insurance COP, IDR and ASIC’s other priorities.

Finity’s five tips for your regulatory reform program:

1. **Streamline your activities** – combine related workstreams to generate efficiencies and reduce duplication of effort and re-work. A product stream and a claims/disputes stream can cover most of the field.
2. **Don’t forget operations** – involve the right people. If your regulatory and legal teams are leading your reform projects, involve operational people early in the process, because there are many operational actions that require a longer lead time.
3. **Don’t boil the ocean** – With the well-known exceptions of consumer credit and motor add-ons, General Insurance products are mostly low risk for consumer harm. Regulatory program responses should be proportionate to the problem.
4. **Don’t panic** – As we regroup, remember that neither government nor regulators will want to create unnecessary compliance burdens in areas where the risk of consumer harm is low. Pick your targets.
5. **Focus on incentives** – behavioural economists will tell you that it is all about the incentives. We agree – no matter how well intentioned your reform program, if the financial and other incentives for your people work against the desired outcomes, then the risk of failure is high.

What does success look like?

How can an insurer or a distributor form a view of how successful it has been with all the reforms?

There is clearly an expectation that each company will need to form a view of its own performance. Boards will need and expect concise and meaningful reports.

ASIC has also said in speeches that it expects insurers to be able to measure their success and, if requested, be ready to provide that to ASIC. The General Insurance Code Governance Committee is likely to have similar expectations.

So it is a good time to start the next phase of the reform process, even though the first two phases are still in flight:

Understanding ▶ Implementation ▶ Evaluation

Evaluation is a challenging task given the number and complexity of the reforms and the nuanced expectations of different stakeholders. Don't forget the goals are about consumers – their outcomes, attitudes and experiences.

The evaluation process needs to be repeatable and not too expensive. It also needs to deal with each product (or product group) and each distribution channel.

We see a clear need to harness new and emerging technology for this task. Known broadly as RegTech, some of the techniques available include:

- **Call listening and automated voice analytics**
- **Social media and chat analytics**
- **Text mining with Artificial Intelligence to identify sentiment and outlier patterns in, for example, complaints and disputes**
- **Sophisticated use of workflow to monitor General InsuranceCOP compliance**
- **Relational analytics techniques.**

Net Promoter Score will no longer cut the mustard. We need to move to being able to capture customer experiences during the relevant interactions rather than relying on the simple NPS survey.

In the rest of this article we look more closely at the reforms in three groups:

- Claims and disputes
- Products and distribution
- Governance and accountability

Reforms affecting claims and disputes

Claims as a Financial Service

The handling and settlement of insurance claims, or potential claims, will no longer be excluded from the definition of 'financial service' under corporations law. This brings claims handling directly under ASIC's regulatory remit and creates a statutory duty to handle claims 'efficiently, honestly and fairly'.

This is one item where legislation is expected before the parliamentary break. There is a long transition period likely because of the extensive need for licensing, possibly out to mid-2022, but there will be partial implementation before that.

Do I need to read on?

You should pay attention if you handle claims from individuals or small business (up to 100 employees) for the following products:

- Motor vehicle
- Home building and contents
- Sickness and accident
- Consumer credit
- Travel
- Personal and domestic property, including pet insurance
- Life insurance.

If you only provide services to wholesale clients or you are a statutory/government insurer, the claims regulations won't apply to you. Lawyers are also exempt when providing legal advice in relation to claims.

Why regulate claims?

The Financial Services Royal Commission heard a number of case studies (more from life insurance than general insurance) regarding unsatisfactory examples of claims handling practices.

Commissioner Hayne recommended that the exemption for claims handling as a financial service should be removed, a request that ASIC had been making for some time.

What is 'handling and settling' a claim?

In practice, the whole of claims handling will be regulated. It will certainly cover insurers, loss assessors/adjusters, third party administrators and brokers with a claims handling authority.

The grey area at present is fulfilment providers (builders, repairers, contents suppliers and the like). This may turn on the extent to which a provider has authority to accept or reject all or part of a claim. Experts, such as doctors, engineers or accountants, are unlikely to be caught. It is unclear where investigators will fall, although there will be more regulation through the COP if nothing else.

Who needs to be licensed? Those involved with handling and settling claims will need to be licensed by ASIC, whether by holding an Australian Financial Services Licence (AFSL) that covers claims handling or becoming an Authorised Representative (AR).

The potential minefield of 'giving financial advice' during claims handling seems to have been avoided. Recommendations or opinions as part of handling and settling a claim are excluded from the financial product advice regime.

However, a 'Statement of Claim Settlement Options' will need to be provided to retail clients if there is an offer to settle all or part of a claim by way of cash settlement.

The overarching obligations as a licence holder or AR will be to handle claims 'efficiently, honestly and fairly'. More specific expectations will be set out in ASIC guidance, as well as the General Insurance COP. For those new to the AFSL regime, don't forget that the Corporations Act has other specific requirements for resourcing, competence, training, IDR and EDR, risk management and the like.

Is CFS an opportunity or a threat?

As with much regulatory change, CFS can be seen as burdensome and costly for little consumer benefit. On the flip side, it can be seen as a stimulus for cultural and process changes that take the industry further along its journey to improved customer-centricity and service delivery.

Internal Dispute Resolution

ASIC released its new Regulatory Guide (RG 271) on complaints handling[2] and dispute resolution on 30 June 2020. It replaces the existing RG 165 for complaints received from 5 October 2021. The lead time to implement system, procedural and resource changes seems reasonable.

ASIC has said it will consult further on the IDR data collection and reporting requirements in the last quarter of 2020, and insurers should be aware that we think these requirements may be quite extensive.

Key take outs for insurers

A broadened definition of complaints

A complaint is defined as an expression of dissatisfaction made to or about an organisation, in relation to its products, services, staff or the handling of a complaint. A relevant social media post is deemed to be a "complaint" if it is posted on an account owned by the insurer, and where the author of the post is identifiable and contactable.

Shorter timeframes for responding to complaints

The maximum timeframe to respond to standard complaints will be 30 calendar days, reduced from the current 45 days.

ASIC expects an acknowledgement of a complaint, verbally or in writing, within one business day of receiving it.

The 30 day time limit for a response can be extended in some circumstances but the complainant must be given an "IDR delay notification" before the 30 days expires.

Identification and management of systemic issues

ASIC emphasises that complaints serve as a key risk indicator for systemic issues warranting early identification and resolution.

Boards need to set clear expectations. Reports provided to board and executive committees must include metrics and analysis of consumer complaints and include systemic issues identified.

Minimum requirements for written IDR responses

A written IDR response confirming the final IDR outcome must include enough detail for the complainant to understand the basis of the decision and to be fully informed when deciding whether to escalate the matter to AFCA or another forum.

2 Not all complaints are about claims, although the majority are. For this reason it is convenient to deal with IDR alongside the claim issues.

Actions needed

The shorter timeframe will require improvements to business processes so that complaints can be resolved promptly and efficiently. There will be heightened requirements for the capture, tracking, analysis and reporting of complaints data.

One operational issue that will be very tricky is that there is no longer an easier path for complaints resolved within five business days, or even for those resolved at first contact. All complaints will need to be captured, recorded and analysed in the same level of detail.

Many organisations will need to bolster resources for IDR. This is also a good time to review and update complaint correspondence and templates to meet the new requirements and improve the quality of written communication and IDR responses.

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Product and distribution changes

Design and Distribution Obligations

DDO will apply to financial products that require a PDS and comes into force on 5 October 2021. The objective is to have products and their distribution processes that are:

- Fit for purpose; and
- Deliver good consumer outcomes.

The core obligation is for the entity that prepares the PDS (usually the product issuer) to make a target market determination (TMD). This is a written statement that describes the class or category of consumers that the product or service is appropriate for. A product is 'appropriate' if it is reasonable to conclude that it would generally meet the likely objectives, financial situations and needs of the consumers.

If multiple products are 'bundled' together in a PDS, a TMD must be prepared for each separate product.

The product issuer then must then:

- Take reasonable steps to ensure distribution is consistent with the TMD;
- Make the TMD available to the public free of charge;
- Keep records of decisions made about complying with these obligations; and
- Treat failure to comply with the DDO as a breach, which may mean notifying ASIC of significant dealings that are inconsistent with the TMD.

A product distributor must not distribute a product without a TMD. They must also take 'reasonable steps' to ensure the product is distributed in a way that is consistent with the TMD. A distributor must keep records of product complaints and report them to the insurer.

The logical consequence is that each insurer, and many distributors, will have developed a **product governance framework,** akin in many respects to APRA requirements on risk management and numerous other functions.

With the commencement date having been deferred from April to October 2021, we think that the industry will benefit from the extra time to fully develop the necessary procedures and documentation. It is a large task with many touch points in operations.

Product Intervention Power

ASIC's new Product Intervention Power (PIP) commenced on 6 April 2019 and is well and truly in use. Regulatory Guide 272 'Product Intervention Power' was released on 17 June 2020 describing how ASIC will use the powers.

Since April 2020 there have been court cases about a pay-day lending product intervention order (PIO), a possible class action related to that case, and consultation for a PIO for continuing credit contracts and one on risk products offered through car yards.

PIP is a very different tool in ASIC's regulatory arsenal. We characterised it as their 'smart bomb' and ASIC itself described it as a 'sniper' with the ability to focus on an individual provider or a narrow market situation.

ASIC has been struggling for quite a while to deal with several 'problem children' in the financial services sector where there has been a persistent failure to provide customers with protection or value for money, even though products may be legally compliant. By using the PIP to force changes to issues such as remuneration arrangements and 'choice architecture', ASIC can both target specific operators and force changes on an industry-wide scale where there are 'first-mover' disadvantages.

A PIO may apply to an individual insurer or it may apply on a market-wide basis. An individual PIO can be made by an ASIC instrument after consultation, while an industry-wide order requires a regulation.

PIOs may be a blessing in disguise if ASIC takes the view that they can be used to 'field test' the Royal Commission Recommendations.

PIOs give ASIC a huge amount of power and are incredibly flexible instruments and that quality should be embraced by the industry.

Unfair Contract Terms

Australia has had Unfair Contract Terms law since 2010, applying to 'standard form' contracts (i.e. a 'take it or leave it' contract). Until now insurance contracts have been exempt but that now changes for contracts entered into from 5 April 2021.

For a consumer to demonstrate that a term is 'unfair' there are three criteria to be met on the balance of probabilities:

- It causes a significant imbalance between the parties in rights and obligations, and
- It is not reasonably necessary to protect legitimate interests of the company, and
- It would cause detriment (financial or otherwise) if it were applied.

Given that all three criteria must apply, the 'legitimate interests' is a key defence for an insurer. The onus is on the insurer to prove that the term reasonably protects its legitimate business interests and does no more.

There are some terms that cannot be challenged as unfair, specifically those that:

- Define the main subject matter of the contract;
- Set the upfront price payable (the premium or deductible); or
- Are required, or expressly permitted, by law.

The 'main subject matter' is defined narrowly as terms that describe what is being insured, for example a house, a person or a motor vehicle. It does not extend to what that subject matter is being insured for.

There is no case law on insurance contract terms that may be found to be 'unfair', and it is unlikely there will be any more guidance until there are judicial precedents. While there have been many decisions in other industries, it is not simple to translate these to the insurance context.

Deferred sales model for add-on insurance

The deferred sales model for add-on insurance (DSM) has not been actioned since the start of 2020. In January, Treasury released draft legislation, including an Exposure Draft Bill, Exposure Draft Regulations, an Explanatory Memorandum, and an Explanatory Statement and there has been no further movement.

This is not to say that there is no action in this space. Bank lenders agreed to a DSM for consumer credit insurance (CCI) in the revised Banking Code of Practice last year.

The proposed PIO for risk products offered through car yards that was mentioned above was released in August 2020 and has been in some form of consultation since October 2019.

The detailed specifications are obviously important for those impacted, and relevant companies will be well down the path if they have not already withdrawn from these products.

A couple of items of broader interest:

- The deferral period is four days, running from the later of the day the financial commitment is made and the day on which the 'prescribed information' is given.
- Taking advantage of InsurTech, the product seller must provide an online consumer roadmap (or portal) that the consumer can use to buy a product before the four days, after which they can be contacted.

There has been some speculation that the DSM legislation may not be needed, with ASIC using PIOs to achieve the desired outcomes. The car yard PIO is effectively an 18 month trial.

A major difficulty with the draft DSM legislation is the breadth of its application. The draft law applies it to all add-on products, based on a fairly broad definition. Not all add-on products are prone to consumer detriment and some provide insurance that is needed immediately. Examples are parcel insurance in situations where the parcel will be delivered within four days, or motor vehicle rental insurance where the vehicle is required immediately. Other regulatory measures are available for consumer protection in these areas and it may make sense to keep DSM to deal with the most egregious selling methods.

Anti-hawking

The next step with the anti-hawking reform is for ASIC to consult on revisions to RG38 (this guide has been around since 2002), due by the end of 2020.

The issue for product providers is just how to delineate what activities fall each side of the line – what is 'hawking' and what is legitimate sales and cross-selling.

At present the main hints are the examples in the Treasury consultation paper on the legislation.

Example	Customer requests	Provider offers	OK?
1.1	Pet insurance	Life insurance	No
1.6	House insurance	Contents insurance	Yes
1.10	Home loan	Car insurance	No
1.11	Car insurance in general	Specifics – Comp, TPPD, TPFT	Yes
1.12	Car insurance	Home insurance	No
1.13	Buys a car	Motor Comp	Yes
1.4	A mortgage	Home insurance	Yes
RG38 Ex 2	A holiday	Travel insurance	Yes

These examples may or may not change in the final guide, but are the best we have at present.

ASIC has already banned outbound telephone sales of life risk insurance and consumer credit insurance (in Instrument 2019/839).

Governance and accountability

There are three reforms on APRA's plate – prudential standards on Governance & Culture (CPS 220) and Remuneration (CPS 511) and implementation of the Financial Accountability Regime (FAR). While FAR is not imminent we outline the implications for insurers.

The three components are interlinked and all are significant. Here we give some extra attention to FAR.

What is the FAR?

The FAR will extend the responsibility and accountability framework across all APRA regulated entities, as the BEAR did in banking. It is intended to increase transparency and accountability and improve risk culture and governance for both prudential and conduct purposes.

The obligations on insurers and most of their senior executives will be extensive.

Accountability

- The entity and each accountable person will need to:
  - Act with honesty and integrity, and with due skill, care and diligence
  - Deal with ASIC and APRA in an open, constructive and cooperative way – though this will not displace legal professional privilege
  - Take reasonable steps to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the entity
- The entity needs to take reasonable steps to ensure that its accountable persons meet their obligations
- A new obligation for accountable persons is the converse: to take reasonable steps to ensure that the entity complies with its licensing obligations.

Key personnel

An entity needs to ensure that accountable persons cover all aspects of its operations (as well of subsidiaries). None of the accountable persons can be from groups prohibited under the FAR and the entity must comply with APRA and ASIC directions to reallocate responsibilities.

Accountability maps and statements

The FAR classifies entities as either Core Compliance or Enhanced Compliance entities. General Insurers and Private Health Insurers with total assets over $2 billion ($4 billion for Life Insurers) are Enhanced, meaning that compliance obligations will be greater, for example, requiring submission of accountability maps and statements.

An entity can be reclassified from Core to Enhanced if the regulator is of the view that governance and accountability of that entity will be strengthened by developing and submitting these maps and statements.

Notification

The FAR requires entities to notify APRA or ASIC of all instances of:

1. A person ceasing to be an accountable person
2. Any breaches of accountability obligations (by entity or accountable person) or key personnel obligations (by entity)
3. Dismissal or suspension of an accountable person for non-compliance with obligations
4. Reduction of the variable remuneration of an accountable person due to non-compliance.

Deferred remuneration

All FAR entities will have to defer 40% of the variable remuneration for an accountable person for a minimum of four years (if the amount to be deferred is greater than $50,000). Variable remuneration includes short term incentives (STI) and long term incentives (LTI).

If an accountable person breaches their FAR obligations, the entity must have policies that allow for a reduction in variable remuneration.

Key take-outs

The deferred remuneration rules will almost certainly lead to a change in the way that financial services entities pay their senior executive, and we are likely to see a move away from variable towards fixed remuneration. Views differ on whether this would be a good or a bad thing.

The regime of penalties and sanctions is significant. Entities will be prohibited from indemnifying or paying the cost of insuring accountable persons against the consequences of breaching the FAR, presumably creating a market for individual indemnity insurance products.

Insurers will need to apply greater rigour to defining roles, responsibilities and accountabilities for senior executive and Boards. Accountability maps and statements look to be the main tools but insurers will need to review policies including remuneration, incentives and conduct policies and articulate the consequences for breaches.

We hope that changes are built into existing prudential standards regarding governance, fit & proper, remuneration, etc, rather than being outside them or over the top of them.


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