

# DRAFT Regulation Impact Statement – Extending the protection from unfair contract terms to insurance contracts

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## Introduction

This is a draft regulatory impact statement (RIS) for consultation purposes. Treasury invites comments on its contents from interested stakeholders for incorporation into the final RIS that accompanies the Bill, however a Government decision on this matter has been made.

## Background

Since 2010 unfair contract terms (UCT) laws have applied across the economy in most sectors that use standard form contracts in their dealings with consumers. Although the UCT laws apply to most financial products and services regulated by the *Australian Securities and Investments Commission Act 2001* (ASIC Act), they do not currently apply to insurance contracts regulated under the *Insurance Contracts Act 1984* (Insurance Contracts Act).

On 4 February 2019 the Government reconfirmed its commitment to extend the UCT laws to insurance contracts in its response to the *Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services* (the Financial Services Royal Commission).

## Existing consumer protection related to insurance contracts

There are several current protections that aim to prevent policyholders from being negatively impacted by policy terms in insurance contracts under certain circumstances. The rules can be categorised into three groups:

- *Pre-contractual disclosure*: rules for informing policyholders about the terms of the policy before it is entered into;
- *Utmost good faith*: rules preventing parties from relying on terms if to do so would be inconsistent with the doctrine of 'utmost good faith'; and
- *Rules on reliance on specific terms*: rules directed at preventing reliance by insurers on specific types of policy terms in certain circumstances.

## Pre-contractual disclosure

One of the most common situations in which dissatisfaction and perceived unfairness arise in the context of insurance contracts is when an insurer seeks to deny a claim based on an exclusion or limitation on cover that the insured argues was not, until the time of the claim, fully known or understood by the insured.

The issue of protecting insureds from unusual and unexpected limitations on cover was examined by the Australian Law Reform Commission in its 1982 report on insurance contracts. This led to the enactment of the 'standard cover' and 'unusual terms' provisions in the Insurance Contracts Act.

The key current laws governing pre-contractual disclosure for insurance are:

- the 'standard cover' rules in sections 34-37 for certain types of prescribed household/personal contracts;
- the 'unusual terms' rules for other contracts in section 37; and
- Product Disclosure Statement (PDS) rules for retail customers (under the *Corporations Act 2001*).

### ***Standard cover***

The Insurance Contracts Act incorporates the standard cover regime to ensure that there are minimum levels of cover for prescribed events. This regime is deemed to be included in certain classes of prescribed insurance policy, such as home buildings insurance and home contents insurance (other than cover notes and renewals).

If an insurer seeks to limit or exclude its liability in respect of the standard cover, then the insurer must prove that:

- it clearly informed the consumer of the limitation or exclusion in writing before the contract was entered into (or within 14 days if provision before the contract was not reasonably practicable, e.g. telephone sales); or
- the consumer knew of the limitation or exclusion; or
- a reasonable consumer in the circumstances could be expected to have known of the limitation or exclusion.

If the insurer is unable to prove one of these three cases then the insurer will be liable for any losses suffered by a consumer that were caused by, or resulted from, any of the standard events to a maximum limit (usually \$2 million).

In practice, the standard cover regulations are very often rendered non-applicable by the provision to the insured of a policy document (usually contained within a PDS), thereby satisfying the requirement to 'clearly inform' the consumer.

### ***Notification of unusual terms***

There is no standard cover regime for other 'non-prescribed' types of contracts. However, insurers still need to 'clearly inform' insureds in writing, before entering into a contract of the effect of any terms '*usually not included in insurance contracts that provide similar insurance cover*'. Failure to clearly inform an insured of such a clause (for example, an unusual exclusion or limitation) means that the insurer is not permitted to rely on it later.

### ***PDS requirements under the Corporations Act 2001***

Pre-contractual disclosure requirements under the Insurance Contracts Act are commonly overlaid with the requirements under the *Corporations Act 2001* (Corporations Act) to provide policyholders with a PDS. The key criterion for this obligation to apply to insurance contracts is that the client is a 'retail client', as defined in the Corporations Act and Regulations. Simply put, the PDS requirements apply to contracts prescribed for standard cover purposes under the Insurance Contracts Act, and some other classes of insurance. The 'clearly inform' requirements for a PDS are also supplemented by a 'clear, concise and effective' requirement which applies generally under the Corporations Act to material in PDS documents.

### ***Duty of utmost good faith***

Section 14 of the Insurance Contracts Act provides that neither party may rely on a term in a contract if to do so would be to fail to act with 'utmost good faith'. This is linked to pre-contractual disclosure as a court must have regard to whether any notification was given to the other party.

It is up to a policyholder, when their claim is denied, to take action (e.g. through the Australian Financial Complaints Authority) by alleging that reliance on a term was in breach of the duty of

utmost good faith. A successful challenge would normally affect only the contract (and policyholder(s)) that were the subject of the case. The impact would usually be that the insurer would be unable to rely on the term for the purposes of denying an insurance claim.

### Rules on specific terms

The Insurance Contracts Act contains provisions that have the effect of rendering void certain terms, and preventing reliance by insurers on certain types of terms in certain situations. The Act prevents an insurer from relying on a policy term that allows the insurer to vary an insurance contract to the prejudice of a person other than the insurer.<sup>1</sup> This is achieved by making the term void. Regulations may also be made to exempt certain classes of policy from the scope of the rule. The Insurance Contracts Act also restricts an insurer from relying on terms of the policy that require an insured to do (or not do) some act after the contract was entered into in certain circumstances.<sup>2</sup>

## 1. The problem

While these protections prevent some potential negative effects of insurance contract terms for consumers, they do not protect consumers and small businesses from unfair terms. Far from providing a comparable measure of protection against unfair terms, the Senate concluded in its 2017 inquiry into general insurance that the exemption from UCT laws created by the Insurance Contracts Act represented a ‘significant gap in consumer protections’.<sup>3</sup>

Echoing the Senate Committee’s recommendation, the Royal Commission similarly dismissed notions that the Insurance Contracts Act and its regulatory framework were sufficiently robust to justify an exemption from the UCT regime.<sup>4</sup>

### Factors making consumers vulnerable to unfair terms

The Productivity Commission’s 2008 Report, *Review of Australia’s Consumer Policy Framework*, identified a number of factors that make consumers vulnerable when entering into contracts containing unfair terms. These were:

- consumers have limited incentives or capacity to negotiate the removal of specific unfair terms in standard-form contracts as these contracts are intended to minimise transaction costs;
- consumers are unlikely to be aware of the detailed terms and conditions of contractual arrangements as many disclosure documents meet the legal requirements, but are neither read nor intended to be read;
- even if consumers are aware of an unfair term, they trust that this term will not be exploited. Consumers may also not be able to avoid such terms by going to other providers as contract terms are often standardised within an industry; and

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<sup>1</sup> Section 53 of the Insurance Contracts Act.

<sup>2</sup> Section 54 of the Insurance Contracts Act.

<sup>3</sup> Senate Economics References Committee report (2017), *Australia’s general insurance industry: sapping consumers of the will to compare*, paras 5.13 and 5.14.

<sup>4</sup> Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019), *Final Report*, Volume 1, page 304.

- contracts are often lengthy and difficult to understand, and consumers generally have limited time to read and fully comprehend the contract.<sup>5</sup>

There is evidence that the factors identified by the Productivity Commission are prevalent in the market for insurance contracts. For example:

- Retail insurance contracts are overwhelmingly standard-form contracts which are not subject to genuine negotiation. This means consumers and small businesses either have to accept contracts that contain unfair terms, or not purchase the insurance policy.
- Insurance contracts can often be lengthy and drafted using language which may not be easy for consumers and small businesses to understand. General insurance documents can be between 20 to 80 pages in length and often reflect a combination of multiple policies offered by the insurer.<sup>6</sup>
- Policyholders often do not read the terms before entering into an insurance contract.
  - In October 2015, a report by the Insurance Council of Australia found that for home insurance and motor insurance products, only 51 and 37 per cent of respondents respectively had read the PDS.<sup>7</sup> Additionally, research commissioned by ASIC found that only 20 per cent of consumers acquiring home building and contents insurance read the PDS before purchase.<sup>8</sup>
- Consumers tend to focus on the cost of premiums when purchasing insurance and underestimate the importance of the level of cover provided.
  - An ANZ Survey of Adult Financial Literacy in Australia found that only 45 per cent of consumers taking out insurance for the first time consider the general level of cover. Also, only 12 per cent consider more detailed features, such as the benefits included or whether they would be underinsured. These factors are considered by even fewer people in the context of renewing a policy.<sup>9</sup>
- Some consumers rely heavily on insurance sales staff to explain the terms of their policy.
  - A survey of 126 policy holders following the 2011 floods found that 32 per cent only briefly read the policy documents because they relied upon what the telephone sales staff said was important.<sup>10</sup>

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<sup>5</sup> Productivity Commission (2008), *Review of Australia's Consumer Policy Framework*, page 413.

<sup>6</sup> Australian Government (2011), *Natural Disaster Insurance Review*, Final Report, page 99.

<sup>7</sup> Insurance Council of Australia (2015), *Too Long; Didn't Read: Enhancing General Insurance Disclosure*, page 19  
<<http://www.insurancecouncil.com.au/assets/Effective%20Disclosure%20Report.pdf>>.

<sup>8</sup> Australian Securities and Investments Commission (2014), Report 416, *Insuring your home: Consumers' experiences buying home insurance*, page 45.

<sup>9</sup> ANZ (2014), Survey of Adult Financial Literacy in Australia, available at: <<https://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf>>.

<sup>10</sup> Australian Government (2011), *Natural Disaster Insurance Review*, Final Report, page 100.

## 2. Case for government action

Consumers and small businesses entering into insurance contracts should have confidence that the contract is fair. They should also have appropriate remedies when they suffer detriment as a result of unfair terms in the contract. However, while the Insurance Contracts Act contains its own protections for consumers (such as the duty to act with the 'utmost good faith'), they are not the same as the protections provided by the UCT laws. Rather, the existing protections have been shown not to provide equal or greater consumer protection.<sup>11</sup>

Most recently the Financial Services Royal Commission identified a number of case studies that demonstrated the detriment to consumers from the use of terms that may be considered unfair. For example, the AAI Ltd case study in Volume 2 of the Financial Services Royal Commission's Final Report demonstrated the consumer harm from terms that allowed the insurer to pay a claim based upon what it would cost them to rebuild a house rather than the actual cost to the consumer.<sup>12</sup>

More generally, the Financial Services Royal Commission recommended that the number of exceptions and carve outs in general law should be reduced, further underscoring the importance of removing the exemption of insurance contracts from the UCT regime.<sup>13</sup>

The 2017 Australian Consumer Law Review observed that stakeholders generally considered that the UCT laws provided an important and effective protection for consumers under the Australian Consumer Law. It found that businesses have generally sought to adapt to these provisions, with the Australian Competition and Consumer Commission's 2013 industry review of standard form contracts indicating positive levels of business compliance and cooperation.<sup>14</sup>

More broadly, the gap for consumer protection caused by excluding insurance contracts from the UCT regime, and the need to address this gap, has been noted in a number of other reports, including:

- ACCC's Northern Australia Insurance Inquiry first interim report, recommendation 6, page 151;
- 2018 Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Life Insurance Industry, recommendation 3.2, page 49;
- 2017 Senate Economics References Committee, Australia's general insurance industry: sapping consumers of the will to compare, recommendation 11, page 65;
- 2012 House of Representatives Standing Committee on Social Policy and Legal Affairs inquiry into the operation of the insurance industry during disaster events, recommendation 4, page 96; and

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<sup>11</sup> Australian Government (2017), Australian Consumer Law Review, Final Report, page 53.

<sup>12</sup> Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019), Final Report, Volume 2, page 433.

<sup>13</sup> Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019), Final Report, Volume 1, page 17.

<sup>14</sup> Australian Government (2016), Australian Consumer Law Review, Interim Report, page 117.

- 2008 Productivity Commission Review of Australia’s Consumer Policy Framework, Volume 2, recommendation 7.1, page 21.

Government action would seek to:

- ensure consumers and small businesses have the equivalent level of protection when entering into an insurance contract as they do under other financial products and financial services;
- remove terms in insurance contracts that are unfair;
- provide greater protection to consumers that are unable to understand terms and the risks associated with them;
- strengthen incentives for insurers to improve the clarity and transparency of contract terms; and
- provide appropriate avenues of recourse for ASIC and consumers and small businesses where a contract contains an unfair term.

### 3. Policy options

This Regulation Impact Statement identifies three possible options for addressing the existence of unfair terms in standard form insurance contracts:

- **Option 1** – maintain the status quo;
- **Option 2** – apply UCT laws to insurance contracts, with a broad definition of main subject matter; and
- **Option 3** (preferred) – apply UCT laws to insurance contracts, including a narrow definition of main subject matter.

#### Option 1: Maintain the status quo

Under this Option there would be no additional regulatory measures put in place to enhance consumer and small business protection from unfair terms in insurance contracts. Consumers would rely on existing remedies in the Insurance Contracts Act, including:

- provisions which mean that neither party may rely on a term in a contract if to do so would be to fail to act with the utmost good faith;<sup>15</sup>
- the ‘standard cover’ rules for certain types of prescribed household/personal contracts;<sup>16</sup>
- the requirement to notify consumers about ‘unusual terms’;<sup>17</sup>
- the voiding of terms which allow the insurer to vary an insurance contract to the prejudice of a person other than the insurer;<sup>18</sup> and

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<sup>15</sup> Sections 12-15 of the *Insurance Contracts Act 1984*.

<sup>16</sup> Sections 34-37 of the *Insurance Contracts Act 1984*.

<sup>17</sup> Section 37 of the *Insurance Contracts Act 1984*.

<sup>18</sup> Section 53 of the *Insurance Contracts Act 1984*.

- insurers not relying on policy terms that require an insured to do (or not do) some act after the contract is entered into.<sup>19</sup>

Consumers would also continue to rely on protections under the Corporations Act and the ASIC Act, including:

- the prohibitions on misleading or deceptive conduct, and the making of false or misleading representations; and
- the licensing, disclosure and conduct regime which applies in respect of the issue, sale and distribution of financial products, including insurance policies.

### **Option 2: Apply UCT laws to insurance contracts with a broad definition of main subject matter**

Option 2 would involve amending the Insurance Contracts Act to permit the current UCT law to apply to insurance contracts. This option would involve some tailoring of the UCT law so that it applies effectively to insurance contracts. This will involve amending the definition of upfront price payable to include excesses and deductibles that are transparently disclosed and enabling third party beneficiaries to bring actions under the law.<sup>20</sup>

Amending the definition of upfront price payable for insurance contracts will provide certainty for insurers that the quantum of excesses and deductibles transparently disclosed will not be subjected to the UCT law.

Allowing third party beneficiaries to take action will ensure that beneficiaries to a standard insurance contract will be protected from UCT when the original party is no longer able to take action.

However, the application of UCT law provisions to insurance contracts will be limited by leaving the main subject matter of an insurance contract defined broadly, that is, the main subject matter would be defined in line with European standards as “*terms which clearly define or circumscribe the insured risk and the insurer's liability*”.<sup>21</sup>

### **Option 3: Apply UCT laws to insurance contracts including a narrow definition of main subject matter**

Option 3 would also involve amending the Insurance Contracts Act to permit the current UCT law to apply to insurance contracts. Like Option 2, this would involve tailoring the UCT law so that it applies effectively to insurance contracts, including amending the definition of upfront price payable to include excesses and deductibles that are transparently disclosed. However, the main subject matter will be narrowly defined for insurance contracts as ‘what is being insured’, in line with the recommendation of the Financial Services Royal Commission. The UCT law will also be amended to

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<sup>19</sup> Section 54 of the *Insurance Contracts Act 1984*.

<sup>20</sup> Section 11 of the *Insurance Contracts Act 1984*.

<sup>21</sup> European Council Directive 93/13/EEC of 5 April 1993.

allow third party beneficiaries, as defined in the Insurance Contracts Act, to take action in certain circumstances.<sup>22</sup>

The adoption of a narrow definition for main subject matter will ensure that the UCT law can be applied to most terms in an insurance contract. The Royal Commission and recent reviews have found that adopting a broad definition of main subject matter may result in large parts of insurance contracts being excluded from the application of UCT laws. Adopting the narrow definition will prevent this from happening, ensuring consumers and small businesses can confidently rely on the protections offered by the UCT laws.

## 4. Cost benefit analysis

### Option 1: Status quo

Under this option there would be no change in the regulatory costs for the insurance industry. Consumers and small business would be unable to rely on the protections offered by the UCT law when entering into insurance contracts regulated by the Insurance Contracts Act. However, they would continue to be able to access the protections available in the Insurance Contracts Act and the Corporations Act.

While there would be no change to the regulatory costs, consumers and small businesses will continue to suffer detriment from the presence of unfair terms in insurance contracts. Though this cannot be accurately quantified, a useful comparison can be made against other sectors of the economy where the UCT regime has been implemented. In 2013, an ACCC inquiry into the effect of UCT laws in the airline, telecommunications, fitness and vehicle rental industries found that 79% of unfair terms were removed by the major airlines after the ACCC found certain terms to be unfair.<sup>23</sup> When UCT was extended to small business contracts, ASIC reported that the major banks had removed unfair contract terms in their small business loan contracts.<sup>24</sup>

In short, the positive experience of UCT in other industries suggests a significant opportunity cost under this option by refraining from extending the UCT regime to insurance contracts.

More broadly, in the absence of regulatory change consumers and small businesses will continue to be unable to effectively assess what their actual cover is under an insurance contract. There is a growing body of work that demonstrates that Australian consumers are unable to effectively assess insurance policies even without having regard to unfair terms.<sup>25</sup> The presence of unfair terms only adds further complexity and causes more consumers to either be underinsured or to opt out of the insurance market all together. Higher levels of underinsurance will also have an impact on the broader economy as consumers and small businesses will not be as financially resilient. For example,

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<sup>22</sup> Section 11 of the *Insurance Contracts Act 1984*.

<sup>23</sup> ACCC (2013), Report, Unfair Contract Terms – Industry review outcomes.

<sup>24</sup> ASIC (2017), media release 17-271MR, Big four banks change loan contracts to eliminate unfair terms, 24 August.

<sup>25</sup> See for example Insurance Council of Australia (2017), *Consumer Research on General Insurance Produce Disclosures* and Malbon, J. & H. Oppewal (2018), *(In)effective disclosure: An experimental study of consumers purchasing home contents insurance*.

it will take longer for consumers and small businesses to recover from natural disasters which may necessitate government intervention, such as subsidised loans and welfare payments.

### **Option 2: Apply UCT laws to insurance contracts with a broad definition of main subject matter**

Option 2 adopts a broad definition of terms that describe the main subject matter in a contract, which are terms not subject to challenge under the tests of unfairness and cannot be made void. Adopting a broad definition will result in terms that clearly describe the risk that is transferred (or not transferred) from the policyholder to the insurer being excluded from the UCT regime.

This definition would mean terms such as exclusions or conditions in the policy that seek to minimise the risk to the insurer are likely to be part of the main subject matter of the contract, and therefore cannot be considered unfair.

#### ***Impact on consumers and small businesses***

Under Option 2, it is expected that insurers would review their contracts for unfair terms and remove or update these terms as appropriate. The removal of unfair terms would provide protection for consumers and small businesses from potential or actual detriment resulting from these terms.

Providing consumers and small businesses with protections against unfair terms would allow them to have their complaints resolved through formal channels, including by making a complaint to ASIC (which has power to take court action on consumers' behalf) or by taking the matter to court.

However, under a broad definition of main subject matter, the number of terms subject to UCT provisions in an insurance contract is likely to be restricted, possibly limited to non-risk related terms in a contract, such as how claims are handled.

These changes are unlikely to affect the ability of businesses to compete in the market or their incentives to compete, meaning consumers and small business will not be disadvantaged by a lessening of competition.

#### ***Impact on insurers***

In relation to the regulatory impacts imposed on insurers under Option 2, these would include reviewing and making any necessary amendments to standard form insurance contracts, which for most insurers will involve obtaining external legal advice.

The estimate is based on feedback to Treasury's proposal paper suggesting the legal costs of reviewing a large insurer's standard form contracts may cost \$30,000-\$40,000.<sup>26</sup> However, this estimate is likely to vary depending on the insurer. Insurers would also incur additional internal costs in reviewing standard form contracts and updating documentation and processes, sometimes in collaboration with other parties.

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<sup>26</sup> Law Council of Australia (2018), Submission to UCT Consultation, Para 17, 27 August 2018.

- For example, ASIC and the Australian Small Business and Family Enterprise Ombudsman have been working with the four major banks to ensure their small business contracts meet the standards required by the UCT laws in the ASIC Act.<sup>27</sup>

Treasury estimates that the initial administrative cost of making these changes will be in the order of \$3.5 million for the industry.<sup>28</sup>

Option 2 may also have an impact on the price of insurance contracts subject to the UCT regime. With some terms subject to challenge and avoidance, insurers will carry some additional risk of future claims being higher than is currently the case. Insurers may respond to this uncertainty by increased premiums or reducing cover for standard form contracts. It is unclear how material any price impact of Option 2 would be, however a broad definition of main subject matter would be expected to have a very limited impact.

### *Impact on other stakeholders*

Option 2 will also impact ASIC as it will now be required to enforce UCT laws for insurance contracts. The additional costs to ASIC are likely to be small, as a proportion of its existing resources are already dedicated to enforcing UCT laws for other financial products and services. ASIC's effectiveness as a regulator would also improve as it would now have the ability to address unfair terms in insurance contracts.

### **Option 3: Extend the UCT laws to insurance contracts with a narrow definition of main subject matter**

The key difference between Option 2 and Option 3 is the definition of terms that describe the main subject matter in a contract. Option 3 will extend the UCT laws to insurance contracts in the same way as Option 2, but will include a narrow definition of main subject matter. This will result in an increased number of terms being subject to the fairness test under the law, thereby increasing the benefit to consumers and small businesses and also the likely impact on insurers. Option 3 is expected to provide the greatest net benefit as a result and is the preferred option.

### *Impact on consumers and small businesses*

Consumers will benefit from the removal of unfair contract terms in insurance, similar to the case in Option 2. However, it is expected that there will be additional benefits for consumers under this option as the main subject matter will be defined narrowly. This will allow a broader range of terms to be subject to the UCT law with only a handful of terms in insurance contracts, such as the description of the thing insured, excluded from challenge under the fairness test.

The inclusion of third party beneficiaries will ensure the protections of the UCT law are available to a wider range of consumers and small businesses than would otherwise be the case. Third parties would otherwise be unable to access the UCT law despite being consumers or small businesses and would consequently not be protected from the detriment caused by unfair terms.

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<sup>27</sup> See also Australian Securities and Investments Commission (2018), Report 565, *Unfair Contract Terms and Small Business Loans*.

<sup>28</sup> This is based upon 73 insurers (not including reinsurers and run-off businesses) and 29 life insurers, with costs varying between \$8,000 to \$184,000 for an insurer to review and amend all their contracts. The cost variation reflects, amongst other things, the different sizes of insurers and the type of insurance they offer (i.e. general or life).

These changes are also unlikely to affect the ability of businesses to compete in the market as they are applied consistently across the market, or to lessen insurers' incentives to compete.

More broadly, reducing the use of unfair terms would also:

- lead to a more efficient allocation of risk, as unfair terms could no longer be used to shift risks onto parties who are not prepared to manage them; and
- encourage a stronger adherence to the ethical principle of fairness in contractual dealings between insurers and consumers and small businesses.

### *Impact on insurers*

The administrative costs imposed on insurers under Option 3 are likely to be similar to Option 2, that is, insurers will incur a one-off cost of approximately \$3.5 million, predominantly the legal costs of reviewing standard form contracts and updating them.

Insurers have also raised concerns that in addition to the administrative costs of the amendment, the changes will result in higher prices for consumers. This is because insurers will not be able to rely on contractual terms that define the risk held by the insured. Insurers may respond to this uncertainty by increased premiums or reducing cover for standard form contracts. It is unclear how material any price impact of Option 3.

Current UCT laws do have some protections for insurers from terms being declared void. Terms in standard form contracts can only be considered unfair if that term is '*not reasonably necessary in order to protect the legitimate interest*' of the business (12BG(1)(b) of the ASIC Act).

The costs imposed on insurers may also be offset, albeit by an unquantifiable amount, from increased consumer and small business confidence in the insurance industry leading to higher rates of insurance uptake. The costs may also be reduced by the 18 month transition period that allows insurers to incorporate this process into their periodic update and review of their standard form contracts and documents.

### *Impact on other stakeholders*

Option 3 is expected to have a similar impact on ASIC as Option 2. Again, additional costs to ASIC are likely to be small, as a proportion of its existing resources are dedicated to enforcing UCT laws for other financial products and services. ASIC's regulatory function will also expand as it will be required to administer the UCT law.

## **5. Previous consultation**

On 26 June 2018, Treasury released a proposals paper on extending the UCT laws in the ASIC Act to insurance contracts.<sup>29</sup> The paper outlined a model similar to Option 3, including a narrow definition of main subject matter. Consultations were conducted over a two month period and 23 submissions were received from a variety of stakeholders, including industry bodies and consumer groups.

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<sup>29</sup> The Treasury (2018), Consultation Paper, Extending Unfair Contract Terms Protections to Insurance Contracts, <http://treasury.gov.au/consultation/c2018-t284394>

The submissions demonstrated that there is a diversity of views amongst stakeholders. Consumer groups were generally supportive of the narrow definition of main subject matter as it provided consumers with greater protection under the UCT regime. In comparison, insurers and their representatives preferred maintaining a broader definition in line with the European model.

Consumer groups and ASIC also strongly supported the extension of the UCT law to cover third party beneficiaries however, they contend that this should include group life insurance purchased by superannuation trustees.

The Financial Services Royal Commission also considered the application of UCT laws to insurance contracts and consulted with stakeholders as part of its hearings on insurance. It subsequently recommended that the UCT law be extended to insurance contracts in its Final Report.<sup>30</sup>

The Financial Services Royal Commission noted that there was insufficient justification for exempting insurance contracts from the UCT regime. While the Final Report did also acknowledge that there are existing protections in the Insurance Contracts Act, such as the duty of utmost good faith, Commissioner Hayne believed that the UCT law and these protections should operate independently of each other. The Financial Services Royal Commission also recommended that the main subject matter be narrowly defined, as a broader definition would undermine the purpose of extending the UCT law.

The application of UCT laws to insurance contracts has also been the subject of consultations in a number of recent reviews and inquiries. The most recent of these reviews were the:

- 2017 Australian Consumer Law Review;
- 2017 Senate Economics References Committee's inquiry into the general insurance industry; and
- 2018 Parliamentary Joint Committee on Corporation and Financial Services' inquiry into the life insurance industry.<sup>31</sup>

These reviews and inquiries identified similar issues during their consultations including:

- whether any UCT laws for insurance contracts should reside in the ASIC Act or the Insurance Contracts Act;
- how to define the main subject matter of an insurance contract;
- the need for insurers to have certainty about the operation of the legislation given that when a term is found to be unfair it is void under the current UCT law; and
- whether additional tailoring is required for life insurance contracts given some of their unique product features.

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<sup>30</sup> Refer to recommendation 4.7 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report.

<sup>31</sup> The Australian Consumer Law Review and both Parliamentary Inquiries recommended extending the UCT laws to insurance contracts.

The Australian Government has also previously sought to extend the UCT law to insurance contracts regulated under the Insurance Contracts Act, including the introduction of a bill in 2013. Consultations were conducted during the development of the original policy underlying the bill as well as during the drafting of the bill. These consultations also identified that there was no agreement between stakeholders on how best to extend the UCT law to insurance contracts, or even if it was a necessary protection. Stakeholders also disagreed on the scope of main subject matter, with consumer groups supporting a narrow definition while industry groups supported a broader definition.

## **6. Implementation and evaluation**

There is now broad support for the extension of the UCT regime to insurance contracts from consumer groups, insurers and numerous government inquiries. However, there is disagreement between consumer groups and insurers as to the key implementation question, that is, the definition of main subject matter in the law.

As considered by the Financial Services Royal Commission, the Commissioner clearly stated that in his view the adoption of a broad definition of main subject matter would undermine the purpose of extending the UCT regime to insurance contracts. The Government agrees with this view and hence proposes a narrow definition of main subject matter in the legislation as outlined in Option 3, meaning that most terms in insurance contracts will be required to be fair to consumers.

The Government would need to implement these changes through a bill as they require legislative change, rather than by amending regulations or standards. An exposure draft bill has been prepared for public consultation to ensure that it would give effect to the policy outlined in Option 3.

Following public consultation, a final bill will be introduced into Parliament. Once it has passed both houses it will take effect and will begin to apply to all insurance contracts 18 months from that date. The 18 month transition period will allow insurers adequate time to review their standard form contracts and ensure they are compliant with the new legislation.

ASIC would be responsible for enforcing the UCT law and providing any regulatory guidance to assist insurers to comply with their legislative obligations. This would be an extension of ASIC's existing responsibilities as the primary regulator for enforcing UCT laws in financial products and services.