

Review of Retail Life Insurance Advice

- An opportunity for a new beginning

A report funded by the Financial Services Council
and its insurance members

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DISCLAIMER

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1 Executive Summary

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1.1 Introduction

Personal risk insurance (life and income protection) has a long and important history. It is important for people with commitments. Those commitments are generally secured by a person's future earning capacity. If that earning capacity is curtailed through ill health or worse, the outcome can be dire.

The methods through which personal risk insurance is sold can be broadly categorised into 3 sales channels:

1. Financial adviser – through an intermediary, either independent or aligned to an insurer;
2. Bancassurance – where banks sell to their bank customer base alongside banking products;
3. Direct to the consumer – direct mail, telephone, over the counter, online etc where there is no intermediary involved.

Personal risk insurance has to be “sold not bought” – in general, customers need prompting to put in place the insurance cover, hence there is an under insurance problem in New Zealand. In an ideal world customers would recognise their insurance needs and source the insurance themselves, as many do with car insurance, but they do not. If that were the case, “fee for service” would be a viable model to assist customers through the purchase but it is not. As a result insurers remunerate the intermediary on behalf of the customer for discovering the need and putting in place the insurance. When someone other than the customer remunerates the intermediary, a potential for a conflict of interest arises.

In general, direct distribution relies on call centre operators who will be salaried with a performance component that most likely primarily relates to the volume of sales they make. Bancassurance relies on bank staff who again will be salaried with a performance component that similarly will most likely primarily relate to the volume of sales they make.

By contrast financial advisers can be salaried but in the main are remunerated through commissions paid on successful sales. The commission received will vary depending on the volume of business placed with each insurer and will be supplemented with various “soft dollar” incentives driven by volume placed with each insurer. Moving a customer's policy from one insurer to another insurer will generate a new commission payment because the policy is new to the new insurer.

We use the term consultants when we refer collectively to these intermediaries who may be financial advisers, bank staff and staff of direct distributors.

The materiality of the conflict of interest in the sales process depends on the level of the remuneration received. Our work leads us to conclude that the most material conflict of interest arises for financial advisers who are solely remunerated by commission, on both new policies and any replacement policies, and who may also receive volume bonuses and soft dollar incentives. Commission can be two times the first year's premium, volume bonuses can add 30% of premium or more and soft dollar incentives can include overseas trips to attractive locations. A high upfront commission paid on a successful sale incentivises a consultant to firstly make a sale (without which they might not get paid at all) and to sell as much as they can (as that increases their remuneration). So we can end up with inappropriate sales (mis-selling) and inappropriate levels of cover (too high).

A manifestation of this conflict of interest is that personal risk insurance cover is more expensive than it needs to be and can be compromised by inappropriate policy replacement – commonly referred to as “policy churn”. Policy replacement occurs in some instances not because the customer needs a new policy but because it will generate a financial return for the consultant. Inappropriate policy replacement leads to premium rates being higher than they should be, leads to unnecessary policy replacement and may, as a result of non-disclosure of pre-existing health conditions covered by the previous policy and the new policy stand down periods, puts policyholders at risk of having claims declined that would otherwise have been paid. Inappropriate policy replacement harms customers.

The level of motivation for inappropriate policy replacement depends on the sales channel but it all stems from the consultant's financial incentives. It could be a bank employee chasing their quarterly performance payment, the call centre operator wanting the movie tickets on offer or a financial adviser seeking another initial commission on a replacement policy. It is in the last scenario where we see the highest levels of policy replacement.

This report examines the retail personal risk insurance market and in particular the conflict of interest created by high initial commissions paid by insurers on new and replacement policies. It considers these matters and makes recommendations to improve the functioning of that market to achieve better outcomes for customers.

1.2 Why a need for this report now?

The Financial Advisers Act 2008 is being reviewed. Further the timeliness of this report was underscored after the FMA, in January 2015 published, “The FMA's Strategic Risk Outlook 2015” and stated amongst other things:

“Conflicts of interest can arise in both retail and wholesale markets. They can be embedded in certain business models and are easily intensified in smaller markets like New Zealand. If they are not properly identified and managed, conflicts of interest can undermine market integrity and result in poor investor outcomes. When conflicts of interest are combined with information asymmetries, it can be difficult for investors to know whether a market participant is acting in their best interests. Remuneration and incentive arrangements can also reinforce conflicts of interest, particularly when sales staff are remunerated on a volume basis or through certain bonus structures.”

“Aim: Market participants effectively manage conflicts of interest.”

“Through our entity based monitoring, we will focus on distribution models that exacerbate conflicts of interest. In particular, we will look at remuneration arrangements that can lead to conflicted advice or sales, and whether firms have in place appropriate safeguards to prevent mis-selling. These remuneration arrangements may include certain volume-based incentives, up-front commissions and trail commissions.”

“Aim: Sales processes and advisory services reflect the best interests of investors and consumers.”

“Mis-selling of insurance products, including selling products that do not meet the customer’s needs, or churning of customers (rapid turnover of insurance business that is not in the customer’s interest), is also an area of concern. We have received an increasing number of complaints regarding insurance sales and will undertake work to more accurately size the problem. Insurance mis-selling will be included as a key monitoring theme for our team.”

The FMA’s interest in this area is seen from market conduct regulators other countries.

Overall, the various questions raised about the practices of life insurance advisers, life insurance salespeople and life insurers themselves have their genesis in the remuneration structure for advisers.

1.3 Cost to customers and cost to the economy of New Zealand

If we accept personal risk insurance is “sold not bought” and therefore there is a the need for commission, we have to accept a potential conflict of interest in the sales process. The conflict of interest inherent in the sales process, due to the acceptance of the need for commission, is the underlying problem and if that is mitigated to the highest extent reasonably possible we can expect other consequential problems to be reduced. Poorly selected insurance cover and high rates of policy replacement are consequences of this underlying conflict of interest.

Inappropriate policy replacement is a problem. This is true irrespective of sales channel; it adds to cost and places cover for customers at risk. The differing sales channels exhibit differing levels of policy replacement; we believe this reflects the different levels of financial motivation on offer.

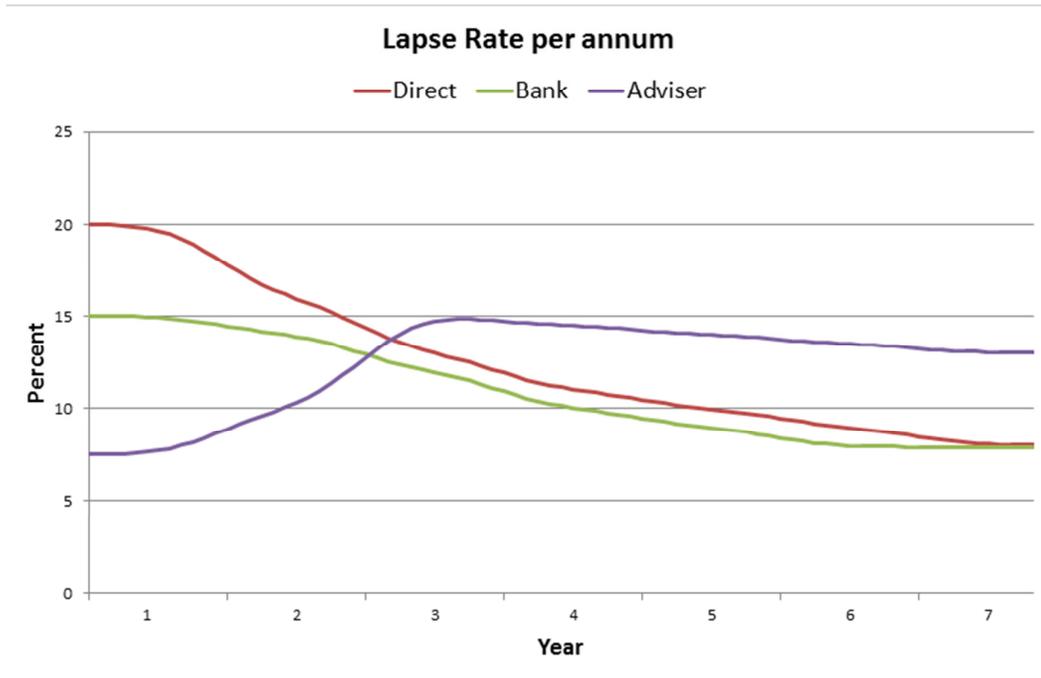
The banks are an increasingly important sales channel using predominantly bank staff. Importantly from the requested data we received from insurers, including bank owned insurers, we see that the level of replacement business written by banks is of the order of 10% which is significantly lower than the replacement business level written through financial advisers at 40% to 50%. We have no data for direct insurers but suspect the level of replacement business to be low.

Financial advisers have a large financial incentive to write life insurance policies. When writing a “new” policy, whether for a new client or as a replacement policy, a financial adviser typically receives 200% of the first year’s premium with other incentives such as overseas trips based on volumes placed with a company taking it to 230%, and 7.5% or 10% of subsequent annual renewal premiums. For a typical policy sold by an adviser the annual premium is \$1,500 per annum and so the initial commission amounts to \$3,000. This creates a material conflict of interest for financial advisers and we believe is a significant contributing factor to the high levels of replacement business being written by financial advisers (almost half of all business written by them).

This situation is extreme. While the rewarding of advisers by initial commissions exceeding one year’s premium is not uncommon in other countries, the New Zealand level, at two times and more, is not only out of line internationally but it also generates inappropriate incentives for advisers and has profound implications for the structure and operation of the life insurance industry in New Zealand.

The following graph highlights the differing pattern of policy lapsation across the three sales channels. Both Direct and Bank exhibit a similar shape of policy lapse: a rate that starts higher and declines over time to a consistent and similar long term rate of lapse. The Adviser curve has a distinctly different shape: it starts low, rises to a peak in the third year and then declines to a stable rate that is distinctly higher than for both Direct and Bank. The jump in year 3 corresponds to the

end of the commission clawback period and indicates adviser-based policy replacement at that point. The commission clawback period is the period during which, if a policy lapses, some or all of the initial commission is claimed back from the financial adviser. Alternatively advisers are suppressing or deferring lapses for poorly sold business in the first two years to avoid commission clawbacks and then there is an elevated rate of lapses for a period while these policies leave the system. The truth is probably a combination of both. However the higher long term lapse rate as compared to Direct and Bank points to an ongoing level of replacement policy activity and is consistent with the replacement business statistics quoted above.



A certain level of replacement policy activity will and should occur with some driven by customer choice. This is healthy when customers' needs change and new policies better suit their needs; it promotes competition between insurers and leads to better outcomes for customers. Inappropriate policy replacement, however, adds cost to the industry and can be to the detriment of customers if they have a claim declined as a result of the policy replacement.

Our analysis, from examining the effect of reduced lapses rates, indicates inappropriate policy replacement activity adds 10% to 15% to industry costs. In a \$1b industry (annual life risk premium) this equates to over \$100m every year in excess cost to customers and to the economy of New Zealand. It is expected that with lower premiums personal risk insurance uptake could be higher than it is now and this would assist in reducing the under insurance problem in New Zealand.

1.4 Clarifying the problem

So what precisely is the problem this report is addressing?

The structure of the current remuneration for advisers leads to poor outcomes for customers of the life insurance industry.

This outcome can be directly related to the current high initial commissions payable by insurers, often more than twice the annual premium, and the low renewal commissions, both of which create conflicts of interest for advisers.

Advisers play a key role in the industry when they provide impartial advice to customers on their insurance needs and place the business appropriately with one or more insurers. They also can play an important ongoing role servicing the customer. The conflicts of interest over remuneration, however, can compromise the impartiality of both the advice and the insurance placement.

Ideally customers would pay a fee for the advice, so removing the need for the adviser to receive a sales commission. However this is not palatable to the vast majority of customers and so advisers are remunerated by commission paid by the insurer. Furthermore, no individual insurer is in a position to wind back these arrangements unilaterally because of the first mover disadvantage (and last mover advantage) whereby the insurer doing so would lose access to the support of advisers who would transfer their portfolios to other insurers.

The high initial commission paid on a policy sale creates for advisers a financial interest in replacing a customer's policy even after a short period in force. This behaviour can be justified in instances where the customer's new policy represents more suitable protection than the replaced one. However there are circumstances when a customer receives a new policy to the benefit of the adviser rather than the customer, and in such cases there is a risk of the cover being inappropriate to the customer's needs.

In summary, the high initial commissions, the high numbers of replacement policies and the costs arising therefrom lead to unnecessary costs for the industry, inappropriate cover for some customers and higher premiums for all.

To elaborate, it is evident that, if these extreme levels of initial commissions could be moderated, so that adviser remuneration was better aligned with adviser costs, a culture change would manifest itself across the industry. Such a change would be to the benefit of consumers generally, to the ability of life insurers to meet consumer needs more effectively and at lower cost, and for advisers to move towards becoming truly professional instead of being dominated by sales-oriented financial incentives.

One may ask why insurers pay such high commissions and, if they are dissatisfied with doing so, why do they not simply reduce them? The answer is the same all around the world and it is in two parts. Firstly, insurers who are heavily dependent on advisers for their business volumes seek the loyalty of advisers by increasing their remuneration levels until some form of market equilibrium is established. Secondly, having found the equilibrium, no single insurer can pull back from this position without compromising its market position and sacrificing its business. In short, the insurers are beholden to the advisers as a whole, and the interests of consumers are subjugated to the interests of the advisers.

The adverse implications of adviser based insurers being beholden to the advisers and the resulting high initial commissions are profound:

- Much of the marketing and sales strategies of insurers are aimed at advisers rather than consumers.
- Companies that operate without advisers, and that includes two of the major banks, charge similar prices to the adviser based insurers but with much lower expense rates. As a result they are able to make very high profit margins rather than passing on the benefits of their lower expense structures to their customers because there is limited price competition in the market across sales channels.
- There is limited customer-oriented innovation or development within the industry, in contrast to various other industries where customer relationship management and genuine customer

orientation are regularly upgraded to deliver efficiencies and improved services to customers over time. Instead attention is focussed on adviser servicing.

1.5 Responding to the Problem

Our response to the conflict of interest inherent in high upfront commissions on both new and replacement policies and associated issues is underpinned by the following positions:

- The opportunity exists for life insurance to play an increasingly important role in the financial lives of most New Zealanders
- There is a need for a better alignment of interests between the three parties involved when a person purchases life insurance, namely the insurer, the consultant and the customer
- Availability of independent financial advice is important
- The payment of commissions by insurers to advisers is justified by the importance of life insurance to the community and its nature, including extensive evidence that consumers rarely buy adequate life insurance protection without the support of a consultant
- When a person takes out a life insurance policy for the first time, adviser costs are higher than on renewal and justify an initial commission that is higher than the renewal commission
- While full commission disclosure is important, it does not on its own lead to a well-functioning competitive market place or resolve conflicts of interest
- Resolving conflicts of interest for consultants and to promote a competitive life insurance industry will require regulatory intervention. This will require the government to legislate.

1.6 Report Contents

The report considers conflicts of interest and remuneration structures present in all distribution channels and their materiality. It proposes solutions applicable to the relevant distribution channel. The report specifically considers:

The impact on the consumer of replacement policy advice:

- The report quantifies the cost of inappropriate policy replacement (lapse rate analysis is used to quantify effects) whilst recognising good policy replacement promotes competition and product innovation. It recognises it is not a simple matter to definitively differentiate between good and bad policy replacement but asserts if the incentive for policy replacement is reduced, policy replacement should reduce. The report addresses the risk to customers of not being covered at claim time as a result of policy replacement.

The current impact on the industry of replacement policy advice:

- The report considers the impacts on lapse rates and costs from high levels of policy replacement and notes that it reduces insurance penetration. Insurance is made more expensive than it could be. It slows industry growth and contributes to the under insurance problem because advisers tend to target existing policyholders rather than potential new customers who have no insurance. It recognises the reputational impacts to the industry of declined claims.

The current role of the insurers in replacement policy advice:

- The report notes how takeover terms show policy replacement is institutionally endorsed and therefore leads advisers to believe it is acceptable practice because the insurers encourage it. It considers making insurers bear the risk of policy switches (unable to void policy for non-

disclosure and ensures broker responsibility as well) thereby ensuring insurers proceed with policy replacement cautiously. The report recommends a code of conduct for the industry and the FMA becoming responsible for market conduct so these issues can be considered in an appropriate and effective forum.

1.7 The impacts of the recommendations in the report are considered to be:

- Replacement business rates are expected to be reduced, possibly halved, resulting in materially lower lapse rates;
- Industry true new business volumes (ie not including policies moving from one insurer to another) should increase as advisers are incentivised to write new to the industry business rather than find policyholders they can move from one insurer to another insurer;
- Insurer costs could eventually reduce 10% to 15% and, if so, premium reductions could be expected in due course;
- Consumer confidence in the industry should lift over time as advisers and insurers focus on the customer relationship;
- Reshaped remuneration will impact advisers materially and business models will have to evolve to accommodate this. Some advisers can be expected to leave the industry.

1.8 Overview of recommendations

The recommendations in the report are set out below.

Recommendation 1 Role of financial advice

We have defined financial advice as covering assessing a client's needs, including affordability, and product types that are suitable for the client.

This needs to be distinguished from product placement, normally given once the customer's needs have been matched against the types of products that might be expected to meet those needs. This product placement role can either be undertaken by a representative employed or contracted to an insurer or involve an independent financial adviser offering a choice of a number of insurers' products.

Fairness to customers requires a clear distinction between an insurer's representative and the independent financial adviser providing complete financial advice.

Recommendation 1A – designations of independent financial advisers and representatives

In our view the roles of advisers and of representatives need to be clarified and we are recommending –

- for independent financial advisers, a move to a single designation only (AFA or Authorised Financial Adviser) and removal of the current RFA role, and
- to accommodate representatives, retention of the category of QFE (Qualified Financial Entity) representative.

Recommendation 1B – the role of AFAs

In order to emphasise the importance and enhance the role of AFAs, we are recommending that –

- AFAs be recognised as, and operate as, independent financial advisers under a requirement that they are able to access the products of multiple insurers,
- when offering advice, AFAs be obliged to comply fully with the FMA Code of Professional Conduct with its duty to act in the best interest of clients and disclose in writing their advice and recommendations on the insurance cover for the client, based on the client's needs, and
- there is created a new governance process for monitoring and ensuring compliance by AFAs with the AFA Code of Professional Conduct involving both the FMA and the adviser professional associations.

AFAs, in having access to multiple insurers, can be expected to understand the full range of products and services available from New Zealand's open market life insurers, of whom there are currently seven, and to prepare their advice in the light of that understanding.

Recommendation 1C – the role of QFEs and their representatives

QFE representatives have lesser obligations than AFAs but still need to act with integrity and provide their clients with products suitable for their needs. In order to sustain and at the same time to clarify the role of QFEs and their representatives, *we are recommending that the role of a QFE representatives remain unchanged but that their disclosure obligations make it clear that their role is to assess client needs and if appropriate to sell their principal's products, and hence that it is a representative role and is not an independent financial advice role.*

Under this recommendation, it is expected that QFE representatives are acting as agents of the insurer via the QFE. They would be obliged to ensure that customers are aware of this arrangement. While the commission will often be payable to the QFE and not the QFE representative, it is seen as important that this remuneration be disclosed in a similar manner as commission to an independent financial adviser.

Recommendation 1D – financial disclosures

In order to inform and protect customers buying life insurance products, *we are recommending that needs analysis (undertaken by both AFAs and QFE representatives) and written statement of advice (prepared by AFAs) be accompanied by a clear explanation of -*

- the premiums associated with the recommended cover
- any commission payable by the insurer to the adviser or the QFE that is included in the premiums,
- the corresponding premiums if there was nil commission.

Recommendation 1E – Simplify the advice and disclosure processes

There are two types of disclosure, one for the advice provided and the other in respect of the individual providing the advice. Simplifying both has advantages to the consumer.

The advice disclosure document appears to be driven more by the defensiveness of the advisers in protecting their legal position than by the goal of communicating effectively with the customer. Similarly the two disclosure documents currently required of an AFA (the primary and the secondary statements) are multi-page documents. Each of these can be simplified and abbreviated in the interests of clear and succinct communication with the customer.

We note incidentally that under the current regime an RFA is not obliged to provide a statement of advice to a customer and is subject to a very limited disclosure requirement. With the proposal to move to just one designation, AFA, this anomaly will disappear.

For this purpose we are recommending that the advisers and insurers work with MBIE to simplify the form and content and method of providing adviser disclosure and with the FMA Appointed Code Committee to develop proposals for a short form advice disclosure statement.

Recommendation 2 Remuneration

The goal is to minimise conflicts of interest within the remuneration structure and to promote the effective servicing of customers during the life of their policies.

Incentives within current arrangements that create conflicts of interest are -

- High initial commissions paid on policies written for new policyholders
- High initial commissions paid on replacement policies written for existing policyholders
- Incentive payments, including volume bonuses and rewards in kind, granted by insurers to advisers beyond commissions. They can generally be characterised as volume-based incentives which act as incentives to increase sales in the interests of the insurer and the adviser but not necessarily in the interests of the customer. These incentives may include “soft dollar” payments such as overseas trips that are awarded on the achievement of agreed sales thresholds.
- Low renewal or servicing commissions, described as low because they are frequently insufficient to meet the genuine servicing needs of policyholders thereby exacerbating the incentive for the adviser to persuade the policyholder to cancel an existing policy in favour of a replacement policy.

The recommendation is twofold –

- to specify a future new model for adviser remuneration that minimises conflicts of interest and promotes the regular servicing of clients; and
- to describe a progressive transition from current arrangements to the new model.

Recommendation 2A - a new remuneration model

The new remuneration model for advisers has lower initial commissions but higher renewal commissions than is common practice today. We rename renewal commission servicing commission to better reflect its role. Note that our recommendations relate explicitly to maximum commissions payable. There is no obligation on any insurer or adviser to use the maximum commission rates.

The recommended new model is -

- **servicing (renewal) commissions** of a maximum of 20% of premiums (instead of, as is common practice today, 7½% to 10%) payable to the adviser nominated by the customer as the adviser currently servicing the customer
- **initial commissions** (which today are commonly 180% to 200% of the first year's premium for all new policies, whether for first time policyholders or for replacement policies of existing policyholders) –
 - for policies written for new customers (i.e. consumers who have no life insurance policies in force): an initial commission not exceeding 70% comprising a 50% initial payment and 20% servicing commission. A cap on the total commission payable would apply based on a premium of \$5,000.
 - for replacement policies written for existing customers (i.e. customers who already have one or more life insurance policies in force) within seven years of inception of any existing policy:

no initial commission unless the premiums are higher, in which case an additional commission not exceeding 50% of the premium increase is payable.

- Volume-based incentives, in cash or in kind, to be banned. Fee-for-service is to be encouraged (and, as noted in the recommended disclosure arrangements for independent financial advisers, nil commission premiums are to be disclosed at all times, even when a commission is payable).

A cap on the dollar amount of commission payable has been included as a way to avoid substantial conflicts of interest in absolute dollar terms recognising that at this level of premium the customer should be encouraged to pay separately for advice on a fee for service basis.

As noted above the commissions stated are maximum commissions. It may be that to support dealer groups (who traditionally have been funded from volume based incentives) advisers will direct some of their commission to their chosen dealer group. For example the servicing commission of 20% could be split 15% to the adviser and 5% to the dealer group.

Where life insurance policies are sold by a QFE representative, those policies are part of the sales process. Nevertheless, the representative is still expected to complete a needs analysis and accordingly it is recommended that in those cases the same maximum remuneration arrangements as for AFAs will apply, including initial commissions. In cases, however, where the customer asks for an execution-only transaction and forgoes any advice or needs analysis, there would be no initial payment made, so that the maximum commissions are level commissions of 20% of premiums.

Hence we are recommending that, for policies sold by QFEs, the same arrangements apply as for AFAs unless it is an execution-only transaction, in which case no initial commissions would be payable.

Recommendation 2B - transition to the new model

It is acknowledged that the existing business models of advisers and adviser groups are built around existing remuneration arrangements. Since the recommended new model involves a substantial reduction in initial remuneration and a different cash flow for advisers, there needs to be a transition process that would enable advisers and adviser groups to rework their business models and to adapt to different remuneration and cash flow arrangements.

There are several ways of designing a transition arrangement. The recommendations require changes in the regulatory framework and there is likely to be an announcement date, for example, middle of 2016, and a commencement date for the transition phase of some later time, perhaps during 2017.

We are recommending that the transition process be along the following lines –

- from announcement date, all the volume-based incentives to be removed or cancelled (any grandfathering arrangements would be limited) and no new ones introduced
- from commencement date, at the adviser's discretion EITHER maximum renewal commissions of 10% and maximum initial payments of 130%, to give total maximum initial commissions of 140% of the first year's premium OR maximum renewal commissions of 20% and maximum initial payments of 80%, to give total maximum initial commissions of 100% of the first year's premium
- from two years after commencement date, the 10%/130% option to cease to yield maximum renewal commissions of 20% and maximum initial payments of 80%, to give total maximum initial commissions of 100% of the first year's premium

- from three years after commencement date, the new model to come into play, with maximum servicing commission of 20% and maximum initial payments of 50%, to give a total maximum initial commission of 70% of the first year's premium.
- the payment of the commission is limited to the first \$5,000 of premium (per life insured).

Regarding replacement policies, we are proposing the same arrangement as under the new remuneration model, i.e. no transition arrangements for replacement policies. Hence *we are recommending that, where a policy is replaced within 7 years of its commencement date, no initial commission be payable, with payments being limited to servicing commission.*

Recommendation 3 Introduce an industry wide replacement policy process – to be brought in under FMA supervision

It is important that customers can safely replace a policy when they consider a new policy would better meet their needs. However there are risks involved and accordingly the customer needs protection.

A tighter approach for issuing any replacement policy along with the recommended changes in intermediary remuneration should reduce the high level of replacement policies issued in the industry while ensuring that legitimate replacement policies are still effected.

The process should be one that provides assurances to the new insurer and protection to the customer. In particular, because there may be risk of non-disclosure when a claim occurs and of a possible claim during any stand down period, the new insurer would be required to provide cover should these events occur.

Therefore we are recommending that the insurers under the auspices of the FMA put in place a structured policy replacement process to protect customers.

Recommendation 4 – FMA to become the market conduct regulator for the life insurance industry

To date the life insurance industry has been subject solely to regulation for solvency purposes, with the RBNZ operating as prudential regulator. There is no market conduct regulator for life insurers. In order to manage the changes necessary to achieve a well-functioning competitive market place for life insurance and to deliver corresponding benefits to customers, we believe that market conduct regulation for the industry should be introduced.

We are therefore recommending that the life insurance industry become the subject of market conduct regulation and that the market regulator be the FMA. This will require the government to legislate so that the FMA becomes the market conduct regulator for the personal insurance industry.

Recommendation 5 The life insurance industry to adopt an agreed Code of Practice – to be brought in under FMA supervision

The industry does not currently have a code of practice. This is in contrast to codes adopted by the NZ banking and general insurance industries. The Insurance Council of New Zealand (ICNZ), the general insurance industry body, has recently adopted a new code known as the "Fair Insurance Code 2016" which comes into effect on 1 January 2016.

The code covers all general insurance products and by definition thereby excludes life and health insurance. An important goal of the code is to raise behaviour standards in the industry, in the interests of consumers.

Our investigations have revealed a number of shortcomings and potential areas of improvement in the practices of life insurers. They can be seen to arise largely from the emphasis that insurers place on satisfying advisers rather than customers and are exacerbated by the conflicts of interest inherent in current commission arrangements.

Accordingly we are recommending that the life insurance industry under the auspices of the FMA develop a consumer-oriented code of practice and that in the first instance it be modelled on the General Insurance Fair Insurance Code.

Recommendation 6 A progress review of industry transformation in 2020

The aim of the report is to feed into the recommendations of the MBIE review of the Financial Advisers Act 2008 initiated by their Issues Paper dated May 2015. The response by MBIE to the submissions made is due later in 2015. A possible timetable for legislative changes will see the Government's response in the middle of 2016 and on the basis that the recommendations find their way into a bill in response to the MBIE review of the Financial Advisers Act, the recommendations are unlikely to be enacted till early 2017 at the earliest.

It is very much the aim of the recommendations made in the report that it will lead to changes in the NZ life insurance industry. These changes are intended to be transformational for the industry, changing the face of competition, the industry structure and most importantly delivering real consumer benefits.

The full consequences of such changes cannot be foreseen in advance and as a result *we recommend a full review is completed once the changes have been introduced to assess their effects.*

Based on our assessment of the timetable for change *we are recommending that a review of all changes made as a result of these recommendations be undertaken in 2020.* The aim of the review would be to assess progress towards a well-functioning competitive market place for life insurance with corresponding benefits to customers and, to the extent necessary, to revise the arrangements then in force.

Recommendation 7 KiwiSaver investors to be able to purchase life insurance cover

The level of life insurance coverage in New Zealand is low compared to most developed countries. This review is concerned with, among other things, expanding the number of people who have the protection provided by life insurance.

On this basis *we are recommending that KiwiSaver members be able to use a portion of their annual contributions to pay for group life insurance cover made available through their KiwiSaver fund once contribution levels have risen to a level able to sustain it.*

1.9 Recommendations in context

As detailed above the report contains recommendations grouped together under 7 headings. The table below cross references a simplified problem statement, our proposed solution and the recommendation that addresses it. This places the recommendations in context to some of the problems they are intended to address.

Problem	Solution	MJW Recommendation
The life insurance industry has not grown in recent years exacerbating the under insurance problem in New Zealand	Package of recommendations for regulatory change to better align interests between insurers, consultants and customers to bring about a culture change for the industry	All 7 recommendations taken as a whole
The reputation of financial advisers is poor and the industry fails to appeal as a career choice	Our key remedy is to bring clarity to the definition of an independent financial adviser and ensure the designation AFA is meaningful	Recommendation 1
High upfront commissions create a material conflict of interest for advisers	We recognise fee for service is not practicable therefore our remedy is to reduce upfront commission to reduce the extent of the conflict of interest and increase servicing commission to bring about a culture change in favour of client servicing	Recommendation 2
High upfront commissions encourage policy replacement	Our remedy is to ban upfront commissions on replacement business. Excessive policy replacement is a symptom of the underlying issue of the conflict of interest and financial motivation. Reducing the conflict of interest and financial motivation should reduce the amount of inappropriate policy replacement	Recommendation 2
The current level of renewal commissions is not sufficient to ensure an ongoing relationship	Our remedy is to lower upfront commissions and boost renewal commissions. We reposition renewal commission as a "servicing commission" and make it able to be directed to an adviser based on customer choice. This will incentivise advisers to maintain customers and insurers to keep products current.	Recommendation 2
Volume bonuses are a conflict of interest and encourage consultants to sell more of the same regardless of customer	Our remedy is to ban volume based remuneration. The end customer receives no benefits from volume based	Recommendation 2

Problem	Solution	MJW Recommendation
need	remuneration	
Insurers not upgrading policies rapidly enough thereby providing a reason to replace the policy	Our remedy is for insurers to pass back advantageous product developments to obviate the need to replace existing policies	Recommendation 3
Customers risk having a claim declined after policy replacement	Our remedy is to remove incentives for replacement other than on the basis of well-established customer need or benefit and to move the risk on policy replacement more to insurers and consultants	Recommendation 3
Insurer market conduct has not enhanced confidence and trust in the industry	FMA to become the market conduct regulator for insurers and to supervise insurers operating under a code of conduct	Recommendations 4 and 5
The under insurance problem in New Zealand	As KiwiSaver matures allow KiwiSaver members to pay for life insurance premiums from their KiwiSaver accounts into cost effective group schemes and thereby bring NZ back into line with the rest of the developed world	Recommendation 7

It is our belief that the recommendations taken as a whole will assist in the establishment of a vibrant and growing personal risk insurance industry that will aid in tackling the under insurance problem in New Zealand. The recommendations if introduced will lead to some dislocation for some industry players. This is a natural and expected outcome of a fundamental shift in the operation and culture of the life insurance industry.

2 Introduction and methodology

This report has at its core the conflict of interest that arises when someone other than the customer remunerates an intermediary for putting in place a personal risk (life and income protection) policy.

New Zealand is not unique in considering this issue nor is this the first time consideration has been given to this issue in New Zealand. Globally, post the GFC, remuneration structures in the financial services sector that incentivise poor behaviour are under regulatory scrutiny. This report has its roots in the current developments overseas concerning the high initial remuneration paid in relation to life insurance and the resulting problem of the material misalignment of interests between customers, advisers, and insurers. The report looks to address this issue along with other major issues which are considered to be preventing the life insurance industry from achieving the goal of delivering life insurance benefits to the average New Zealander from a well-functioning and competitive industry.

2.1 Addressee

The report was commissioned by the Financial Services Council (FSC) and is addressed to its Chair Rob Flannagan.

2.2 Why a need for this report now?

The Financial Advisers Act 2008 is being reviewed and it is timely these matters are considered as part of that review. Further the timeliness of this report was underscored after the FMA, in January 2015 published, "The FMA's Strategic Risk Outlook 2015" and stated amongst other things:

"Conflicts of interest can arise in both retail and wholesale markets. They can be embedded in certain business models and are easily intensified in smaller markets like New Zealand. If they are not properly identified and managed, conflicts of interest can undermine market integrity and result in poor investor outcomes. When conflicts of interest are combined with information asymmetries, it can be difficult for investors to know whether a market participant is acting in their best interests. Remuneration and incentive arrangements can also reinforce conflicts of interest, particularly when sales staff are remunerated on a volume basis or through certain bonus structures."

"Aim: Market participants effectively manage conflicts of interest."

"Through our entity based monitoring, we will focus on distribution models that exacerbate conflicts of interest. In particular, we will look at remuneration arrangements that can lead to conflicted advice or sales, and whether firms have in place appropriate safeguards to prevent mis-selling. These remuneration arrangements may include certain volume-based incentives, up-front commissions and trail commissions."

"Aim: Sales processes and advisory services reflect the best interests of investors and consumers."

"Mis-selling of insurance products, including selling products that do not meet the customer's needs, or churning of customers (rapid turnover of insurance business that is not in the customer's interest), is also an area of concern. We have received an increasing number of complaints regarding insurance sales and will undertake work to more accurately size the problem. Insurance mis-selling will be included as a key monitoring theme for our team."

The FMA's interest in this area is seen from market conduct regulators other countries.

As the FMA has no market conduct role for the life insurance industry the focus of its comments were in regard to the behaviour of the advisers and the sales process and not in regard to the life insurers.

In taking this position the FMA is reflecting similar views expressed around the world from other market conduct regulators. For example in the UK in September 2012 the then Financial Service Authority (FSA) produced a paper entitled “Guidance Consultation – Risks to customers from financial incentives”. In its conclusions and next steps it stated “*Despite many years of warnings about these risks, during the review we found that most firms have incentive schemes that can drive mis-selling, but do not have effective systems and controls to adequately manage the risks. This must change.*” The FMA is looking to protect the average New Zealander from behaviour that impacts adversely on their finances. This stance has subsequently been reinforced by their section 25 notice under the FMC Act for information from life insurers in regard to advisers.

2.3 Background

Personal risk insurance (life and income protection) has a long and important history. It is important for people with commitments. Those commitments are generally secured by a person’s future earning capacity. If that earning capacity is curtailed through ill health or worse, the outcome can be dire.

Personal risk insurance has to be “sold not bought” – in general, customers need prompting to put in place the insurance cover, hence there is an “under insurance problem in New Zealand”. In an ideal world customers would recognise their insurance needs and source the insurance themselves, as many do with car insurance, but they do not. If that were the case, “fee for service” would be a viable model to assist customers through the purchase but it is not. As a result insurers remunerate the intermediary on behalf of the customer for discovering the need and putting in place the insurance. When someone other than the customer remunerates the intermediary, a potential for a conflict of interest arises.

2.4 A conflict of interest

What is meant by the term conflict of interest?

A conflict of interest is a situation that creates a risk that actions regarding a primary interest will be unduly influenced by secondary interest. In our situation the primary interest is to do the best for the customer, a secondary interest is to do the best for oneself. This becomes a problem when the second interest drives behaviour in preference to the first interest and the expected behaviour, putting the customer first, does not occur. In practice determining whether this has occurred is problematic so the usual response is to avoid the situation from occurring, put a fence at the top of the cliff rather than an ambulance at the bottom.

Another way of describing a conflict of interest is a position where you can exploit the situation for your own self-interest. In our situation an adviser can act in their own best interests in preference to that of the customer and benefit financially. So our proposal is to reduce that temptation by reducing the financial incentive.

2.5 The materiality of the conflict of interest

The materiality of the conflict of interest in the sales process depends on the level of the remuneration received. Our work leads us to conclude that the most material conflict of interest arises for financial advisers who are solely remunerated by commission, on both new policies and

any replacement policies, and who may also receive volume bonuses and soft dollar incentives. Commission can be two times the first year's premium, volume bonuses can add 30% of premium or more and soft dollar incentives can include overseas trips to attractive locations. A high upfront commission paid on a successful sale, incentivises a consultant to firstly make a sale (without which they might not get paid at all) and to sell as much as they can (as that increases their remuneration). So we can end up with inappropriate sales (mis-selling) and inappropriate levels of cover (too high).

A manifestation of this conflict of interest is that personal risk insurance cover is more expensive than it needs to be and can be compromised by inappropriate policy replacement – commonly referred to as “policy churn”. Policy replacement occurs in some instances not because the customer needs a new policy but because it will generate a financial return for the consultant. Inappropriate policy replacement leads to premium rates being higher than they should be, leads to unnecessary policy replacement and may, as a result of non-disclosure of pre-existing health conditions covered by the previous policy and the new policy stand down periods, puts policyholders at risk of having claims declined that would otherwise have been paid. Inappropriate policy replacement harms customers.

The level of motivation for inappropriate policy replacement depends on the sales channel but it all stems from the consultant's financial incentives. It could be a bank employee chasing their quarterly performance payment, the call centre operator wanting the movie tickets on offer or a financial adviser seeking another initial commission on a replacement policy. It is in the last scenario where we see the highest levels of policy replacement.

This report examines the retail personal risk insurance market and in particular the conflict of interest created by high initial commissions paid by insurers on new and replacement policies. It considers these matters and makes recommendations to improve the functioning of that market to achieve better outcomes for customers.

2.6 Cost to customers and cost to the economy of New Zealand

If we accept personal risk insurance is “sold not bought” and therefore there is a need for commission, we have to accept a potential conflict of interest in the sales process. The conflict of interest inherent in the sales process, due to the acceptance of the need for commission, is the underlying problem and if that is mitigated to the highest extent reasonably possible we can expect other consequential problems to be reduced. Poorly selected insurance cover and high rates of policy replacement are consequences of this underlying conflict of interest.

Inappropriate policy replacement is a problem. This is true irrespective of sales channel; it adds to cost and places cover for customers at risk. The differing sales channels exhibit differing levels of policy replacement; we believe this reflects the different levels of financial motivation on offer.

The banks are an increasingly important sales channel using predominantly bank staff. Importantly from the requested data we received from insurers, including bank owned insurers, we see that the level of replacement business written by banks is of the order of 10% which is significantly lower than the replacement business level written through financial advisers at 40% to 50%. We have no data for direct insurers but suspect the level of replacement business to be low.

Financial advisers have a large financial incentive to write life insurance policies. When writing a “new” policy, whether for a new client or as a replacement policy, a financial adviser typically receives 200% of the first year's premium with other incentives such as overseas trips based on volumes placed with a company taking it to 230%, and 7.5% or 10% of subsequent annual renewal premiums. This creates a material conflict of interest for financial advisers and we believe is a

significant contributing factor to the high levels of replacement business being written by financial advisers (almost half of all business written by them).

This situation is extreme. While the rewarding of advisers by initial commissions exceeding one year's premium is not uncommon in other countries, the New Zealand level, at two times and more, is not only out of line internationally but it also generates inappropriate incentives for advisers and has profound implications for the structure and operation of the life insurance industry in New Zealand.

2.7 Clarifying the problem

So what precisely is the problem this report is addressing?

The structure of the current remuneration for advisers leads to poor outcomes for customers of the life insurance industry.

This outcome can be directly related to the current high initial commissions payable by insurers, often more than twice the annual premium, and the low renewal commissions, both of which create conflicts of interest for advisers.

Advisers play a key role in the industry when they provide impartial advice to customers on their insurance needs and place the business appropriately with one or more insurers. They also can play an important ongoing role servicing the customer. The conflicts of interest over remuneration, however, can compromise the impartiality of both the advice and the insurance placement.

Ideally customers would pay a fee for the advice, so removing the need for the adviser to receive a sales commission. However this is not palatable to the vast majority of customers and so advisers are remunerated by commission paid by the insurer. Furthermore, no individual insurer is in a position to wind back these arrangements unilaterally because of the first mover disadvantage (and last mover advantage) whereby the insurer doing so would lose access to the support of advisers who would transfer their portfolios to other insurers.

The high initial commission paid on a policy sale creates for advisers a financial interest in replacing a customer's policy even after a short period in force. This behaviour can be justified in instances where the customer's new policy represents more suitable protection than the replaced one. However there are circumstances when a customer receives a new policy to the benefit of the adviser rather than the customer, and in such cases there is a risk of the cover being inappropriate to the customer's needs.

In summary, the high initial commissions, the high numbers of replacement policies and the costs arising therefrom lead to unnecessary costs for the industry, inappropriate cover for some customers and higher premiums for all.

To elaborate, it is evident that, if these extreme levels of initial commissions could be moderated, so that adviser remuneration was better aligned with adviser costs, a culture change would manifest itself across the industry. Such a change would be to the benefit of consumers generally, to the ability of life insurers to meet consumer needs more effectively and at lower cost, and for advisers to move towards becoming truly professional instead of being dominated by sales-oriented financial incentives.

One may ask why insurers pay such high commissions and, if they are dissatisfied with doing so, why do they not simply reduce them? The answer is the same all around the world and it is in two parts. Firstly, adviser based insurers are heavily dependent on advisers for their business volumes, so they seek the loyalty of advisers by increasing their remuneration levels until some form of

market equilibrium is established. Secondly, having found the equilibrium, no single insurer can pull back from this position without compromising its market position and sacrificing its business. In short, the insurers are beholden to the advisers as a whole, and the interests of consumers are subjugated to the interests of the advisers.

The adverse implications of adviser based insurers being beholden to the advisers and the resulting high initial commissions are profound:

- Much of the marketing and sales strategies of insurers are aimed at advisers rather than consumers.
- Companies that operate without advisers, and that includes two of the major banks, charge similar prices to the adviser based insurers but with much lower expense rates. As a result they are able to make very high profit margins rather than passing on the benefits of their lower expense structures to their customers because there is limited price competition in the market across sales channels.
- There is very limited customer-oriented innovation or development within the industry, in contrast to various other industries where customer relationship management and genuine customer orientation are regularly upgraded to deliver efficiencies and improved services to customers over time. Instead attention is focussed on adviser servicing.

2.8 Responding to the problem

Our response to the conflict of interest inherent in high upfront commissions on both new and replacement policies and associated issues is underpinned by the following positions:

- The opportunity exists for life insurance to play an increasingly important role in the financial lives of most New Zealanders
- There is a need for a better alignment of interests between the three parties involved when a person purchases life insurance, namely the insurer, the consultant and the customer
- Availability of independent financial advice is important
- The payment of commissions by insurers to advisers is justified by the importance of life insurance to the community and its nature, including extensive evidence that consumers rarely buy adequate life insurance protection without the support of a consultant
- When a person takes out a life insurance policy for the first time, adviser costs are higher than on renewal and justify an initial commission that is higher than the renewal commission
- While full commission disclosure is important, it does not on its own lead to a well-functioning competitive market place or resolve conflicts of interest
- Resolving conflicts of interest for consultants and to promote a competitive life insurance industry will require regulatory intervention. This will require the government to legislate.

2.9 Report contents

The report considers conflicts of interest and remuneration structures present in all distribution channels and their materiality. It proposes solutions applicable to the relevant distribution channel. The report specifically considers:

The impact on the consumer of replacement policy advice:

- The report quantifies the cost of inappropriate policy replacement (lapse rate analysis is used to quantify effects) whilst recognising good policy replacement promotes competition and product innovation. It recognises it is not a simple matter to definitively differentiate between

good and bad policy replacement but asserts if the incentive for policy replacement is reduced, policy replacement should reduce. The report addresses the risk to customers of not being covered at claim time as a result of policy replacement.

The current impact on the industry of replacement policy advice:

- The report considers the impacts on lapse rates and costs from high levels of policy replacement and notes that it reduces insurance penetration. Insurance is made more expensive than it could be. It slows industry growth and contributes to the under insurance problem because advisers tend to target existing policyholders rather than potential new customers who have no insurance. It recognises the reputational impacts to the industry of declined claims.

The current role of the insurers in replacement policy advice:

- The report notes how takeover terms show policy replacement is institutionally endorsed and therefore leads advisers to believe it is acceptable practice because the insurers encourage it. It considers making insurers bear the risk of policy switches (unable to void policy for non-disclosure and ensures broker responsibility as well) thereby ensuring insurers proceed with policy replacement cautiously. The report recommends a code of conduct for the industry and the FMA becoming responsible for market conduct so these issues can be considered in an appropriate and effective forum.

The impacts of the recommendations in the report are considered to be:

- Replacement business rates are expected to be reduced, possibly halved, resulting in materially lower lapse rates;
- Industry true new business volumes (ie not including policies moving from one insurer to another) should increase as advisers are incentivised to write new to the industry business rather than find policyholders they can move from one insurer to another insurer;
- Insurer costs could eventually reduce 10% to 15% and, if so, premium reductions could be expected in due course;
- Consumer confidence in the industry should lift over time as advisers and insurers focus on the customer relationship;
- Reshaped remuneration will impact advisers materially and business models will have to evolve to accommodate this. Some advisers can be expected to leave the industry.

2.10 Outline of report

The report is set out as follows:

- **Chapter 3 - Overview of the industry** We provide an overview of the NZ life insurance industry looking at the developments in the industry over the last 25 years and the current main issues and the structure of the both the insurers and the adviser industries.
- **Chapter 4 - Basic policy propositions** We set out the basic policy propositions upon which we have developed the recommendations.
- **Chapter 5 - Analysis of the data collected** We requested data off the insurers in regard to some of the important issues and we include our analysis of and the results thereon.
- **Chapters 6 to 9 - Recommendations** The review has seven recommendations and for the remainder of the report we detail the basis for the recommendations shown in full in the Executive Summary.

2.11 Production of the report

The time available for the report was limited and this was taken into account when determining the approach to be followed. Unlike reviews in other jurisdictions we have not been able to:

- Ask industry players to complete a survey concerning the issues; or
- Request detailed data nor been able to complete in depth data analysis, or
- Further consult via an interim report.

In some respects we are fortunate when approaching this work that we can draw on the results in other jurisdictions. Clearly the reviews and reports in Australia have provided valuable information for the review, as have a number of papers from the UK.

Work on the report did not start till July and with the need for the FSC to feed the findings into the MBIE review process for their “Options Paper”, we needed to complete the report for some time in October.

2.12 Research

There is no substitute to meeting the stakeholders and talking to them on the issues. Fortunately the issues involved are high in the minds of all parties due to the submissions most will have made to the MBIE “Issues Paper”. A list of the parties consulted is identified in Appendix A. The parties comprised:

- The adviser professional associations. We met with four.
- The insurers. We held discussions with personnel from ten insurers.
- Representatives of some of the main adviser groups.
- Government agencies – FMA, MBIE, RBNZ and Commission for Financial Capability.
- Individual advisers and other industry participants.
- Consumer representatives including Consumer NZ

In some cases we talked to a party more than once. Where appropriate we have made reference to comments made to us in the meetings. But no comments are attributed to any party.

2.13 Data request

To complete the review we needed to collect good information from the insurers on which to base the conclusions in the report. Accordingly we asked the insurers for information on:

- Lapses
- Commission rates
- “Soft dollar” benefits
- Split of business by channel, age and gender
- Whether the insurer offered takeover terms to advisers to incentivise them to switch customers
- Average premium for policies sold
- Profit levels.

Full details on the data request are included in Appendix C.

2.14 Peer review process

The recommendations have been discussed with John Trowbridge. We have found his contribution invaluable due to his recent experience in Australia. But when considering his work in Australia we have been mindful that NZ and Australia are different markets and are driven by different factors albeit that the basic issue of a misalignment of interests is universal and not bound by a particular country's regime. MJW take full responsibility for the recommendations made.

The subject matter for the report is extensive and it is important that our understanding of the life insurance and adviser market is complete. Time did not allow us to issue a draft report or circulate a full version to selected parties. Instead, over the last few weeks we have chosen to talk, to the findings of our work and the recommendations we expect to make, to a small number of industry players. We are indebted to them for their time and effort in this respect. We have listened to the points made to us and taken on board an important number of the issues.

As expected in our discussions many different views were expressed to us and we have endeavoured to be fair and reasonable in considering all the points put to us. As one would expect we have formed our own views.

2.15 Industry statistics

We have drawn on the quarterly statistics compiled by the FSC.

2.16 Qualifications/limitation

We have not attempted to cover all the different topics in the report in detail rather ensure that our summary of an issue is correct such that the results can reasonably be fed into the recommendations made. While more time would of course enable us to provide a more in depth review we are satisfied that we have covered all the issues as required in order to arrive at our recommendations. The matters relating to the designations of financial adviser compared to salesperson, and what constitutes financial advice are not simple subjects.

In a number of places we have made estimates of costs and of the impact that changes to costs could make on premium levels. The results need to be considered illustrative and not definitive.

2.17 Terminology

We have chosen to use the term advisers to describe both aligned and independent advisers. Where required we make a distinction between the different types of roles. And we use the term consultants when we refer collectively to these intermediaries who may be financial advisers, bank staff and staff of direct distributors.

2.18 Terms of reference

Attached as Appendix A are the agreed terms of reference for the report. Included with the original terms of reference is an addendum to the terms of reference that was provided to MJW after a review of an early draft of the report. The addendum reflects the fact some members of the FSC believed there were some matters covered in the report that are outside of the intended scope. This is still the case as noted in the disclaimer to this report from the FSC. MJW is satisfied it has addressed the matters expected of it in the production of the report. The report is an independent report expressing the views of MJW. The report should be read in its entirety.

3 Overview of the New Zealand Life insurance industry

The life insurance industry in New Zealand comprises a mixture of traditional companies relying on adviser distribution, bank owned insurers who rely either on distribution to bank customers only or also on adviser distribution and insurers who also use direct sales as a distribution channel.

The methods through which personal risk insurance is sold can be broadly categorised into 3 sales channels:

1. Financial adviser – through an intermediary, either independent or aligned to an insurer;
2. Bancassurance – where banks sell to their bank customer base alongside banking products;
3. Direct to the consumer – direct mail, telephone, over the counter, online etc where there is no intermediary involved.

In general, direct distribution relies on call centre operators who will be salaried with a performance component that most likely primarily relates to the volume of sales they make. Bancassurance relies on bank staff who again will be salaried with a performance component that similarly will most likely primarily relate to the volume of sales they make.

By contrast financial advisers can be salaried but in the main are remunerated through commissions paid on successful sales. The commission received will vary depending on the volume of business placed with each insurer and will be supplemented with various “soft dollar” incentives driven by volume placed with each insurer. Moving a customer’s policy from one insurer to another insurer will generate a new commission payment because the policy is new to the new insurer.

Our review has considered 10 members of the FSC as at the end of June 2015 and for whom we could access data. Our report therefore looks at the 10 insurers which between them write around 99% of the business reported in the FSC market statistics.

The distribution channels of these insurers are:

- Principally adviser distribution 5
- Solely bank distribution 2
- Both adviser and bank distribution 2
- Direct distribution 1

This report focusses on individual risk business, which means policies that provide benefits on death and various forms of illness or disability. This is the vast majority of the industry’s new business. While some insurers still have substantial portfolios of traditional products (“bundled” whole of life and endowment policies as well as “unbundled” unit-linked policies) still in force, these are running off as it is a number of years since such products were sold in any volumes. We have made only passing reference to the more specialised group risk insurance market.

3.1 Why our focus is on advisers

As noted in the introduction this report examines the retail personal risk insurance market and in particular the conflict of interest created by high initial commissions paid by insurers on new and replacement policies. It considers these matters and makes recommendations to improve the functioning of that market to achieve better outcomes for customers. Therefore the report has a focus on advisers.

3.2 Outsourcing – a history of distribution

We have chosen to commence this review by considering this issue as it is central to where the industry is today and the problems that exist.

Up until the mid-1980's, the insurers mainly distributed their products through their in-house aligned sales forces. The first insurer to seriously distribute its products through non-aligned (independent) advisers was the US insurer Aetna Life which commenced business in NZ in the 1980's. This created a climate for aligned advisers to consider their earning potential as non-aligned advisers.

The insurers' approach to distributing their products changed when they decided they would assist their employees in setting up independent agency forces. These decisions may have been seen as a way of reducing costs and possibly to add more sales motivation to their agency forces or a response to the rise of non-aligned advisers but, whatever the motivation, and the advantages with the approach, the outcome has seen:

- Insurers having less control over their distribution than previously
- The advisers, while always the prime contact for the customer, being able to further distance the insurers from the customers
- The rise of some large independent adviser groups (as advisers aggregated to earn volume bonuses higher up the scale) and the gradual increase in their bargaining position with the insurers distributing through the adviser channel
- As the insurers competed for new business, the level of the remuneration paid to the advisers progressively increasing.

An important point here, which we recognise, is that the historical remuneration levels quoted will have been after the allowance of certain costs being met by the insurers. These costs are now borne by the advisers themselves.

3.3 Overview of the last 25 years the insurers

Up until the late 1980's the industry was dominated by the mutual companies, the Australian Mutual Provident Society, National Mutual, Colonial Mutual and Government Life, all of which demutualised during the 1990s. The market also included a number of UK life subsidiaries, examples of whom were Prudential, Provident Life, and Norwich Union. Starting in the late 1990's we have seen the exit of the UK insurers as they sold their New Zealand businesses to the Australian insurers.

Since then the market has seen the formation of five new life insurers:

- Sovereign, which was sold to ASB in 1998,
- Kiwi Insurance in 2002,
- Club Life, which was sold to ING in 2003,
- Pinnacle Life which began as a partnership and is now a privately-owned company and
- Partners Life which started writing business in 2011.

More recently, the life risk business of Tower was taken over by Fidelity Life. The historical traditional Tower business was purchased by a run off company Foundation Life.

The new insurers have in some cases been heavily dependent on global reinsurers to finance the growth of their new business and meet the heavy cash strain arising from the initial commissions paid to advisers.

3.4 Industry statistics

The following table provides a picture of the growth of the industry over the last 10 years. The table shows the results in respect of risk business e.g. term, disability income and trauma cover. It excludes the figures for the older types of policies which are no longer actively sold, namely the traditional whole of life and endowment policies, the contracts which bundled both investment and life cover. Group business is also excluded. Over the last 10 years the retail risk business has more than doubled from \$862 million to \$1,986 million of premiums in force.

FSC Industry Statistics - Individual Risk business

	Year ending 30 June			% increase to 2015	
	2005	2010	2015	5 years	10 years
	\$m	\$m	\$m		
Annual Premiums					
In force	862	1,415	1,986	40%	130%
New Business	139	214	231	8%	66%
Contractual premium increases	57	98	155	58%	172%
Lapses, cancellations etc.	100	175	254	45%	154%

The table shows that annual premiums have risen over the 2005 to 2015 period as follows:

- In force \$862m to \$1,986m 130% increase
- New business \$139m to \$231m 66% increase
- Contractual premium increases \$57m to \$155m 172% increase
- Lapse, cancellations etc. \$100m to \$254m 154% increase

While we see a strong increase in the premiums collected each year over the 10 year period, the premiums for new business have increased by a much smaller percentage over the same period and are overshadowed by the contractual premium increases and the increase in lapses.

The table further shows that the picture appears to be getting worse. Lapses as a ratio were 80% of new business levels in 2005, 90% of new business levels in 2010 and 110% of new business levels in 2015. The contractual premium increases as a ratio were 40% of new business levels in 2005, 45% in 2010 and 67% in 2015 which reflects the continued emergence of yearly renewable business.

The concentration of new business annual premiums for individual risk business has changed over the 10-year period 2005 to 2015.

- Sovereign has remained top, but its market share has declined from 30% in 2005 to 23% in 2015.
 - AMP/AXA was second in 2005 with 15%, but by 2015 had dropped to 8th with 6%.
 - Partners Life, which started in 2011, was second in 2015 with a 15% share.
 - Asteron has increased from a 6% share (7th) in 2005 to 10% (4th) in 2015.
 - AIA has moved from a 10% share (3rd) in 2005 to 5% (9th) in 2015.

3.5 Comparative global insurance coverage levels

The weak growth in the New Zealand market is brought home when we compare the relatively low level of life insurance (including income protection) with the levels in other markets as illustrated in the table below.

Annual life premium per capita of population	
Country	NZ\$
Hong Kong	5,071
United Kingdom	3,638
Ireland	3,058
Japan	2,626
France	2,552
Australia	2,382
United States	1,657
Canada	1,469
Germany	1,437
NZ	401
China	127

Source Swiss Re sigma No 4/2015

When considering the above we note:

- The role ACC plays in the market.
- No account taken of differing income levels in each country.
- The New Zealand business excludes investment business and the impact on the market of tax concessions which we presume drive some of the activity in the other markets.

3.6 Policy design

Historically customers would buy life policies with the clear understanding that the policies were to cover them for a long time and perhaps for life, with the annual premiums fixed at inception. Endowment and whole of life policies, with their built-in savings or investment element and their penal surrender values, saw policyholders maintaining them not only because of the insurance protection but also to protect their investment.

In the last 20 years or so, however, with the advent of a full scale funds management industry, policy design has moved from these older traditional policies to risk only cover, with no investment component. One of the consequences is that it has become much easier for advisers to sell replacement policies to their customers. The changes can be summarised as follows:

- The insurer can revise the premiums annually and the insurer sets the basis such that the premiums increase annually as the probability of the incidence of a claim rises
- The virtual elimination of level premium business
- The benefits covered have expanded beyond life cover only with trauma now a regular feature of many policies
- The range of benefits under the trauma policies has grown
- Income protection insurance has developed to become a major product

- The policies no longer have any surrender values, so making it easier for customers to cancel them and in many cases not see a need to retain them (notwithstanding that existing policies offer guaranteed insurability).

Hence while the insurer has the flexibility to vary the premiums in the future, customers have the certainty that once accepted and underwritten, their policies offer guaranteed cover for the future life of the policy.

It is notable, however, that as insurers have competed against each other their products have become more complex; with many features which are increasingly of questionable real value – insurers talk of features with high perceived value but of little cost. There are regularly instances of claims where a customer receives a payment but has suffered no demonstrable financial loss i.e. policies have moved to betterment as opposed to an indemnity basis. As noted in the report the range of benefits under a trauma policy has grown from less than 10 to 50 plus benefits.

3.7 Replacement business

In chapter 5 the data from the insurers gave a figure of 40% to 50% for the level of new business written by advisers which is new policies issued in respect of customers who previously had a policy. We do not have any figures which track this percentage over time but we note that previously replacement business was frowned upon in the industry. We have a position where it is easier for an adviser to replace the policy of an existing customer, and similarly replace the policy of another adviser's customer, due to those customers having already accepted the need for insurance, than find a new customer.

3.8 Change in tax regime leading to increase in premiums

The tax regime applicable to life insurance was revised 5 years ago in response to the widely accepted view that the previous tax basis, which began when the industry's products were quite different, had become unduly favourable. The new regime has increased the tax impost.

All new term insurance business written after 1 July 2010 was taxed under the new regime and a transition period for renewable term business expired on 1 July 2015. One consequence has been a need for the industry to increase premiums. We understand that, to date, some insurers have chosen not to increase their premium rates, which may be putting the industry's finances under some stress.

3.9 Improved prudential supervision regime

The Insurance (Prudential Supervision) Act 2010 received the royal assent on 7 September 2010, with various provisions coming into effect at different times.

The Act is administered by the Reserve Bank of New Zealand for the purposes of promoting the maintenance of a sound and efficient insurance sector and promoting public confidence in the insurance sector. It applies to all insurers carrying on business in New Zealand (as defined by the Act) and includes:

- a licensing system for insurers, based on meeting the Act's prudential requirements,
- supervision by the Bank of compliance with the prudential requirements and
- powers for the Reserve Bank to act in respect of insurers in financial distress or other difficulties.

The industry is also subject to regulations made under the Insurance (Prudential Supervision) Regulations 2010, as well as a number of guidelines and reporting requirements.

The first Solvency Standard for Life Insurance Business was issued by the Reserve Bank of New Zealand in August 2011. Prior to that, actuarial guidance notes and standards issued by the NZ Society of Actuaries had existed for a number of years; while actuaries had to apply the provisions in giving advice to insurers, there was no onus on insurers to accept that advice. An updated Standard was issued in December 2014 after consultation with the industry.

Other features of the regime include, inter alia:

- all insurers are required to have an appointed actuary, who has various specified responsibilities including:
- writing a Financial Condition Report which includes review of the insurer's operations, finances and approach to risk management,
- assessing the insurer's current and expected future solvency position and
- preparing a "Section 78 Report" which must be attached to the insurer's annual financial statements,
- insurers are required to obtain and publish a claims paying ability rating from a recognised rating agency,
- some recognition of regulation in other jurisdictions,
- requirement for fit and proper certification of directors and relevant officers, including appointed actuaries,
- insurers must disclose any preference given to overseas policyholders,
- life insurers must place certain classes of business in statutory funds,
- various reporting requirements.

There are limited exemptions for insurers with annual gross written premium less than \$1.5m.

The current RBNZ guidelines are listed below.

- Application for a licence
- Fit and proper policy
- Risk management programme requirements
- Governance
- Insurers that have not yet commenced business
- Exemptions for small insurers
- Transfers and amalgamations
- Statutory fund requirements (life insurance)
- Carrying on business in a prudent manner
- Restriction on the use of words associated with insurance
- Fit and proper certificate

3.10 Growth of the bank insurers

Based on the FSC industry statistics for the June 2015 year we have estimated the following split of new business written by the different insurers. The estimated split for June 2005, 10 years previously is shown in brackets:

Advisor	64%	(78%)
Bank	29%	(15%)
Direct	7%	(7%)

The picture is one of the banks successfully growing their market share over the last 10 years at the expense of the insurers who distribute their business through advisers. Note that for the purposes of the above numbers we have needed to make some assumptions for the two insurers who have both bank and adviser distribution channels. A feature of these two bank owned insurers is their gradual move away from the adviser channel and their focus on the bank distribution channel.

The growth in new business captured by the banks can be put down to:

- Their captive bank customer base to whom making a secondary life insurance sale can be relatively straightforward.
- The banks having leveraged the direct and on-going relationship they have with their customers to market to them other non-banking products. Witness the success they have enjoyed expanding their share of the KiwiSaver market.

A contention of this review is that the traditional companies with their adviser distribution networks have overly focussed on the needs of their advisers and not placed enough attention on their customers and this has ultimately cost them market share to the banks. An interesting example of this is the slowness of the life insurers to provide internet access for customers to their policy details. Contrast this with the online portals insurers have for their advisers and banks for their customers.

We also see that the direct channel has made limited progress over the 10 year period.

3.11 Agency agreements

An important component for insurers issuing policies through advisers is the agreements in place which enable the advisers to sell the insurer's products. Apart from the details of the commission terms, the main terms of the agreements cover:

- The conditions under which the agreement may be terminated by either party,
- requirements re completion of an 'Advice on Replacement Business' form where appropriate, with distribution of copies,
- the insurer's right to approve any potential purchasers of an adviser's client base,
- any requirement to maintain a specified persistency rate in order to continue to write business for the insurer,
- a requirement for the adviser to use all reasonable endeavours to ensure that any staff they employ or contract to sell or promote the insurer's products also comply with the terms of the agreement.
- provisions re repayment of commission debt,

- limitation of commissions if the adviser is responsible for premium payments on a policy or the policy provides benefits on the adviser's own life or on the life of a family member or business associate of the adviser and
- any requirement to hold professional indemnity insurance during the term of the agreement and after the agreement has been terminated.

In most instances renewal commission vests in the adviser for the duration of a policy and the customer has no say as to whether it should be payable to a new adviser. One consequence of this is that when advisers come across a customer who already has an adviser, they are motivated to sell the customer a replacement policy in order to gain any remuneration. There is no alternative such as taking over the remuneration in respect of the existing policy. This is considered in a later section of the report.

3.12 Adviser numbers

The current shape of the industry has been influenced by the Financial Advisers Act 2008 passed in September 2008 but which did not fully come into effect until July 2011.

Under the Financial Advisers Act there are three types of individual "financial advisers":

- Authorised Financial Advisers (AFA) Authorised by the FMA
- Registered Financial Advisers (RFA) Registered with the FMA
- Qualified Financial Entity (QFE) personnel.

There are currently registered with the FMA 57 QFE entities.

The table below gives our estimate of the numbers for each type of adviser who are involved in the selling of financial products.

Number of advisers	
AFA's	1,900
RFA's	6,000
QFE employees	5,000

The number for the RFA's includes a high number who are not actively involved in the industry on a day to day basis but instead make occasional sales.

As a generalisation, AFA's focus on the investment products while RFA's sell risk products. AFA's are able to sell both category 1 and 2 products while RFA's are limited to selling just category 2 products which include risk products, the presumption being that risk products are less complex than category 1 products.

Within the adviser market we see:

- Independent advisers working either individually or within an independent entity
- Advisers aligned with an insurer and:
 - limited to selling just their products
 - able/expected to sell other insurer's products

- Adviser groups wholly owned by an insurer
- Adviser groups with ownership split between an insurer and the advisers.

The majority of QFE personnel are bank employees.

3.13 The adviser business development groups - the dealer groups or “aggregators”

As the insurers chose to outsource their distribution so we have seen the rise of the independent adviser groups. Initially their principal purpose was to allow advisers to share certain middle office costs including compliance costs, sales leads, customer relationship management systems and market knowledge while in the main leaving them as independent operators.

However in some instances these groups exist with the prime function of negotiating aggregation remuneration terms for their members. A member of a group automatically receives the highest levels of volume bonus available from an insurer irrespective of their own levels of business produced. This can increase the rate of remuneration to an adviser by up to 100%.

For arranging this, the groups receive remuneration of up to 30% of the annualised premium on the policies issued by their members. An important feature here is that the dealer groups have in most instances no contractual rights to on-going renewal commission.

Some dealer groups also provide training for new entrants to the industry.

3.14 Industry bodies

There are a number of industry bodies for advisers and advisers frequently belong to both an industry group and a dealer group with the industry body firmly focussed on matters of interest to the industry and less so on specific business issues. The industry bodies also have disciplinary committees. There are a number of these bodies with the two main ones being the PAA and IFA who respectively have 1,100 and 750 members. These bodies trace their history back to associations established by individual insurers.

3.15 Rise of the policy comparison website

Advisers play an important role for their customers by providing information on how a policy compares with others in the market. There are comparison websites that provide this service to advisers and provide information covering an insurer's:

- Credit rating
- Policy features with a summary rating
- Premiums.

Whether intended or not these sites have made it easy for advisers to demonstrate why a new replacement policy provides better apparent benefits than a customer's current policy. We touch on this issue further when we look at the issue of replacement policies in chapter 8.



3.16 No market conduct regulator

The focus of the introduction of the new tougher financial services regulatory regime in New Zealand has been on investment products and was clearly driven by the finance company implosion at the time of the GFC. Accordingly we have seen the FMA given jurisdiction to manage the market conduct of entities offering investment products and people providing financial advice. In contrast there is no such regime on life insurance companies. This is in contrast to Australia where we have APRA as the solvency regulator and ASIC as the market conduct regulator. In New Zealand the RBNZ is solely concerned with solvency and not the market conduct of the life insurers.

Embargoed until 5am 23 November 2015

4 Policy positions that underpin the report

4.1 Policy positions that underpin our recommendations

Our report is underpinned by the following policy positions:

1. The opportunity exists for life insurance to play an increasingly important role in the financial lives of most New Zealanders.
2. There is a need for an alignment of interest between the three parties involved when a person purchases life insurance, namely the insurer, the consultant and the customer.
3. Access by consumers to independent financial advice is important.
4. The payment of commissions by insurers to advisers is justified by the importance of life insurance to the community and its nature, including extensive evidence that consumers rarely buy adequate life insurance protection without the support of an adviser.
5. When a person takes out a life insurance policy for the first time, adviser costs are higher than on renewal and justify an initial commission that is higher than the renewal commissions.
6. While full commission disclosure is important, it does not on its own lead to a well-functioning competitive market place or resolve conflicts of interest.
7. To resolve existing conflicts of interest of advisers and to promote a competitive life insurance industry will require regulatory intervention.

To the extent that any of these positions is not self-evident, the foundation for the position is elaborated on in the remainder of our report.

Embargoed until 5am 23 November 2015

5 Review of the data requested from insurers

5.1 Data requested

It was important for the review to obtain good quality data from the insurers on the key issues we are reviewing and accordingly we sent a data request to the insurers - a copy of which is included in Appendix C. Summarising the request we asked for:

- Commission rates both initial and renewal, and details on overrides and variations to terms for an adviser
- The percentage of new business identified as replacement business
- Lapse rates by policy and duration and by period, to allow us to identify any current trends
- The total initial commission paid in the past 12 months expressed as a % of annual premiums
- Age information for new customers
- Average premium for new customers.

If possible we asked for the information to be split by originating distribution channel and adviser type. The information by adviser type was limited.

We received data from all the key players and the parties responding have been split by their principal distribution channel(s) as follows:

- Adviser only 5
- Bank only 2
- Adviser and bank 2
- Direct 1
- Total 10

We comment that the distribution channels for each insurer are not exclusively as shown above. For example with limited exceptions all the insurers will have some direct business while some will also have some franchise arrangement i.e. their products are distributed under another party's brand e.g. NZ Automobile Association.

In regard to the two insurers who distribute through both advisers and the bank we have made assumptions as to the proportion for each channel.

5.2 Proportions of new business by distribution channel

The results from the responses are shown in the table below; our estimate of the position 10 years ago is shown in brackets:

Advisor	64%	(78%)
Bank	29%	(15%)
Direct	7%	(7%)

We comment as follows:

- The percentage of business through the adviser channel has reduced. It has probably been boosted in the last few years by the emergence of Partners Life.
- The banks have doubled their share.
- The direct channel is growing very slowly.

5.3 Percentage of new business which is replacement policies

We asked for a split by channel but the answers we received were limited. It appears from the responses that the range of replacement business is between 25% and 50%. However other statements made publically and the majority of responses support 40% to 50% of adviser based business being replacement policies. The percentage of bank new business which is in respect of replacement policies appears much lower at 10%.

5.4 Takeover terms

We asked whether an insurer offered "takeover terms" for business in the period from 1 April 2011 and if yes what were the terms offered and the volume of business received?

Only one company said they offered takeover terms and we did not pursue the details of the offers made as they said very little business eventuated. This practice encourages policy replacement by advisers as it gives it institutional support.

5.5 Commission terms

We asked for an outline of commission terms offered to advisers over the last 12 months covering commission in the broadest sense i.e. including volume bonus overrides and including trips, office support, marketing assistance, shares etc offered directly to advisers or via dealer groups. An estimate for the percentage paid in the last 12 months was requested with information on the maximum and the minimum paid in respect a policy.

The commission (remuneration) terms insurers offer have complicated structures that vary by product. In general they do allow for spreading of the commission over time but the upfront scenario is clearly the most popular. The spreading of commission can lead to commission of up to 30% level throughout the term of a policy. However this level option is not often taken.

The structures can be generalised as a base commission, a volume bonus, a quality (or persistency) bonus, dealer group commission and then the cost of soft incentives such as trips and prizes. Combined these often exceed 200% of the first year's premium (on both new and replacement policies) and can amount to 230%.

The commission scales are best summarised by the averages paid. The answers then, as might be expected, become tightly bunched as all the companies are forced to offer effectively very similar terms. Including soft dollar incentives (which add approximately 15% of the annual premium) the range of average commission paid is 180% to 205%. The maximums can exceed 230% and the minimums go down to below 100%.

5.6 Renewal commissions

The average commission paid in the last 12 months in respect of policies with the maximum initial commissions paid varied between 7.5% and 10.0% of the annualised premiums.

5.7 Commission clawback rules

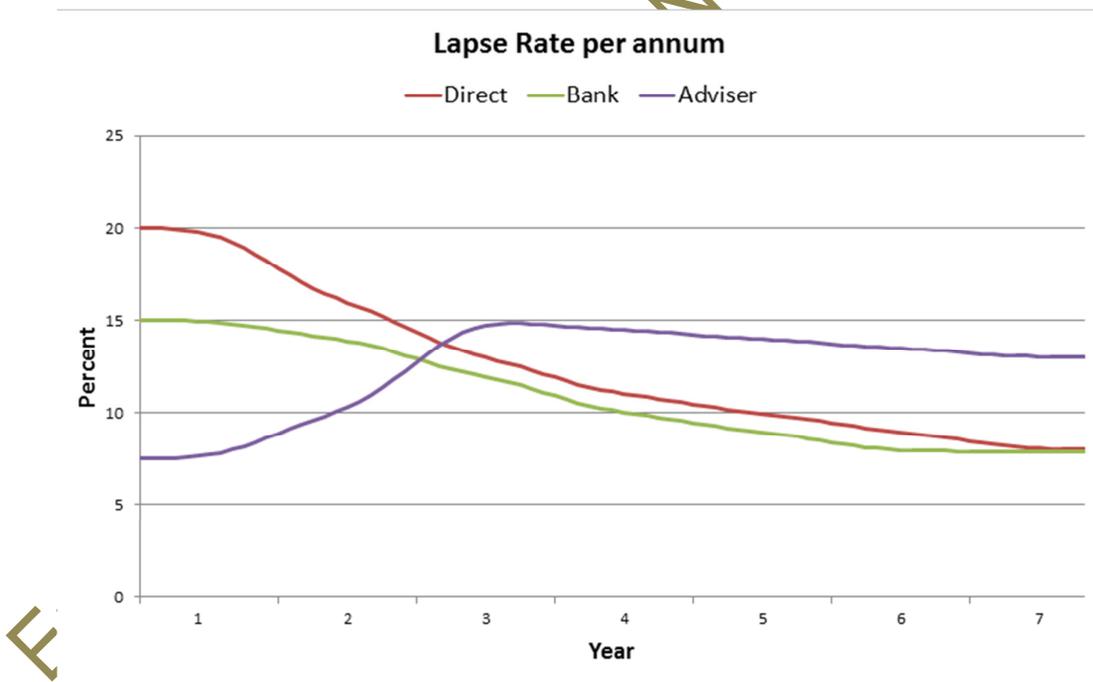
For adviser based business all the insurers have clawback periods of 24 months. The scales vary within this but not appreciably.

5.8 Lapse rates

We asked for information on the insurer's lapse rates by product and over the last 4 years.

The insurers do not analyse lapses in a uniform manner and some could not provide analysis for the last 4 years. For those that did there was no discernible trend for the period.

The lapse rates were viewed as the most commercially sensitive information we collected. As a result we have decided to present a graph showing the relative shapes of lapses for the three sales channels: direct, bank and adviser.



5.9 Average premium of new policies issued in the last 12 months

We were interested in the average premium for a policy issued in the last 12 months split if possible by distribution channel and ideally by AFA, RFA, and QFE representative.

The insurers reported this in varying ways and the average premium size for adviser based business varied between \$650 and \$2,400 with an average premium sale per customer of around

\$1,500. This varied significantly whether medical business was included. Banks tended to have smaller policy sizes which might in part be explained by the answer to the question below.

5.10 Average age by gender of a new customer in the last 12 months.

The responses to this question were remarkably similar. For adviser based business the average age for males was just over 40 and for females approximately 2 years younger. However for bank derived business the average age for males was lower at 33 and females were one year older at 34.

A general observation on the operation of the life insurance market can be made here. For self-employed people, adviser distribution dominates because self-employed people will likely have a "broker" relationship for the other forms of insurance they need. Bancassurance is more dominant in the younger age groups and increasingly so in the homeowners group as banks are dealing with their customers at this stage in their life when their life insurance need crystallises. In other countries group life schemes also play a key part for employees. In New Zealand the prevalence of group insurance is much less which is a consequence of our superannuation arrangements.

Embargoed until 5am 23 November 2015

6 Recommendation 1 – Strengthening the advice role

In this section we set out our recommendation regarding the role of financial advice.

6.1 The role played by of the adviser

Advisers play a key role in the industry when they provide impartial advice to customers on their insurance needs and place the business appropriately with one or more insurer. They can also play an important ongoing role servicing the customer. The conflicts of interest over remuneration, however, can compromise the impartiality of both the advice and the insurance placement. We seek to eliminate the conflicts.

A client will have the following needs when working with either an independent financial adviser or a product representative:

- An assessment of their current financial position, personal circumstances and risks that are relevant to insurance protection
- A discussion on and establishment of their financial and risk objectives to complement their wider personal goals
- Being made aware of the appropriate type of insurance cover and the cover level, both to meet their needs and within their available budget.
- Agreement to review their needs on an agreed regular basis.

Independent financial advisers will have more product choices to offer a client while product representatives will need to be clear on whether the product they have available will be suitable to meet the client's needs.

For the client the overriding consideration is that they need to be fully aware as to whether they are in a process delivering independent financial advice or they are being sold one of the insurer's products.

We see the opportunity for life insurance to play an increasingly important role in the financial lives of New Zealanders and we want there to exist a safe environment for the purchase of life insurance. We do not want potential customers to be wary of buying insurance. We do not want them to be suspicious of the industry. For the industry to play its potential role we need to empower customers with the ability to distinguish between an advice environment and a sales environment - this is part of creating this safe space.

The report holds the policy position that access to financial advice is important and so we need clarity on what constitutes financial advice. Accordingly we have defined financial advice as covering: assessing a client's needs, including affordability, and product types that are suitable for the client.

This needs to be distinguished from *product placement*, normally given once the customer's needs have been matched against the types of products that might be expected to meet those needs. This product placement role can either be undertaken by a salesperson employed or contracted to one insurer or involve a person offering a choice of a number of insurers.

Fairness to consumers requires a clear distinction between the two, i.e. between providing financial advice that may lead to the recognition of a need for a life insurance product and advice in regard to which product the customer may purchase.

We want all the interests of all parties involved in the sale of a policy - the customer, the adviser and the insurer to be in alignment i.e. we want each party to have full cognisance of the role each is playing in the process by which the customer purchases a life policy. We want to avoid impressions created that customers are receiving independent advice when they are not and we want clarity that the customer is receiving independent advice when this is the case.

While we have stressed the value of customers receiving independent financial advice there is also a major role for the product representative to play within the industry. If we look at the role played by the banks they have good distribution channels which can more easily reach new customers in contrast to the adviser based insurers. As we noted in section 3.10 their share of the market is growing and as we saw in section 5.2 the data received from the insurers illustrates how the banks are reaching a different audience to the adviser market – their customers tend to be younger, have lower premiums (i.e. they are reaching a customer base which might otherwise struggle with affordability of the product) and they have a higher percentage of females. This is all very positive for the industry in growing its penetration of the total New Zealand market. This section of the market is not reached by the normal advisers. So this relatively new and different distribution channel has had a positive effect on the industry. In time one can take the view that these younger customers may well be able to and want to take independent advice – so benefiting the adviser market in the future.

An issue we wish to tackle here is the one of the huge challenge faced by all countries in raising the financial capability across the community. In New Zealand the need to raise this capability is one of the roles of the Commission for Financial Capability. The Commission has over the last 12 to 18 months strengthened its ability to reach more people from more diverse backgrounds and is considered to be making progress. Other factors which will further enlighten the customer are the development of robo advice platforms which on their own will deliver advice to customers. At this moment they are more prevalent for investment products but in time they will progress to include protection products as well. In NZ we have the Smart Kiwi website which provides independent advice on the relative merits of the different KiwiSaver providers and is funded by the users and not by the providers - so truly is independent.

The internet is of course driving much of this development and websites such as LifeDirect are providing more information to customers on their financial choices. The ability to readily access financial knowledge will enhance and not diminish the demand for personal financial advice.

6.2 Designations of independent financial advisers and representatives

As noted a customer's ability to distinguish between advisers and representatives is important.

The distinction for customers as to whether they are being sold a product as opposed to being provided with independent financial advice is unclear under the current regime. In part that is because the definition of "financial advice" includes any recommendation or opinion on buying or selling a financial product. That is broader, intentionally, than the common meaning of the term and consequently difficult to avoid in a sales situation. The confusion is compounded because the concept of class advice and personalised advice under the regime is not apparent to a customer.

The picture is further confused with the two designations of AFA and RFA for a person advising on a financial product. It has been unsatisfactory the way that the value offered by the AFA qualification has effectively been diminished by the current disclosure regime. The position is such that with the lower disclosure requirements for an RFA and reduced level of risk and compliance, we have seen a number of AFA opt instead to operate as an RFA. This is a poor outcome for the consumer as an RFA is not subject to a code of conduct and so not obligated to act to the same degree in the best interests of a customer.

In our view RFAs should either become AFAs or they should have to work within a QFE. The QFE framework ensures the entity takes responsibility for them. The reason for this is RFAs are in reality unregulated at present as disciplinary action is difficult and the FMA has insufficient resources to chase individual advisers except in the most egregious of circumstances.

Our recommendations on how to best resolve the above is:

Recommendation 1A

- For independent financial advisers, a move to a single designation only (AFA or Authorised Financial Adviser) and removal of the current RFA role, and
- to accommodate representatives, retention of the category of QFE (Qualified Financial Entity) representative.

6.3 The role of the AFAs

While we first needed above to make the distinction between the financial advisers and product representatives we need to clarify the role of the AFAs. Ideally the designation should deliver the trusted adviser position they were originally planned to have when the Financial Adviser Act was being introduced in 2008. They are subject to the AFA Code of Professional Conduct which sees them obligated to act solely in the client's interest while in contrast an RFA is only required to provide a suitable product and act with integrity to the client.

In order to stress the independence of the financial adviser role there is a need for AFAs to have a range of products available to them. When sitting with a customer they need solutions from multiple insurers so enabling them to choose a product which is suitable for the customer. There are a limited number of insurers in the market. In our estimation there are seven insurers who an adviser can choose from. The seven comprise five insurers whose principal distribution channel is advisers and just two banks who in addition to their distribution through the bank have an adviser channel.

AFAs will need to make their own judgement on the service provided by an insurer, consider their customer's financial exposure by considering the insurer's credit rating and form their view on how easy it is to deal with an insurer at the time of a claim.

The current regime provides for a customer to be provided in writing details of their advice and recommendations based on the customer's needs and this needs to continue.

Recommendation 1B

- AFAs be recognised as, and operate as, independent financial advisers under a requirement that they are able to access the products of multiple insurers,
- when offering advice, AFAs be obliged to comply fully with the AFA Code of Professional Conduct with its duty to act in the best interest of clients and disclose in writing their advice and recommendations on the insurance cover for the client, based on the client's needs, and

and as explained at the end of this chapter:

- there is created a new governance process for monitoring and ensuring compliance by AFAs with the AFA Code of Professional Conduct involving both the FMA and the adviser professional associations.

6.4 The role of the QFE representative

Some insurers want to be able to sell their own products to customers and this is accommodated under the current regime by the QFE designation. Subject to the proviso of whether or not the customer properly understands the QFE representative's role the approach has generally worked and we see no need to change the overall approach. As noted previously above, the banks have been successful in growing the life insurance market in New Zealand.

Recommendation 1C – the role of QFEs and their representatives

The role of QFE representatives to remain unchanged but that their disclosure obligations make it clear that their role is to assess client needs and if appropriate to sell their principal's products, and hence that it is a representative role and is not an independent financial advice role.

Under this recommendation, it is expected that QFE representatives are acting as agents of the insurer via the QFE. They would be obliged to ensure that customers are aware of this arrangement. While the commission will often be payable to the QFE and not the QFE representative, it is seen as important that this remuneration be disclosed in a similar manner as commission to an independent financial adviser.

6.5 Financial disclosures

The current regime requires an AFA, RFA and a representative of a QFE to all make a primary disclosure statement. The requirement for an AFA is more extensive and in addition to the initial disclosure statement there is a secondary disclosure statement.

The disclosure statements are in addition to the statement of advice and needs analysis provided to a customer. The customer needs to further receive full information on the premiums they are liable to pay for the cover recommended, including a projection for a suitable period such as 10 years.

Consistent with the ideal of the customer paying for the advice separately we consider the financial disclosure should include information on the premium if no commission was payable. This would give the customer the option to pay separately for the advice. This can apply equally for a QFE representative with the customer able to separately pay for the advice. Accordingly the recommendation is:

Recommendation 1D – financial disclosures

That needs analysis (undertaken by both AFAs and QFE representatives) and the written statement of advice (prepared by AFAs) be accompanied by a clear explanation of -

- the premiums associated with the recommended cover
- any commission payable by the insurer to the adviser or the QFE that is included in the premiums, and
- the corresponding premiums if there was nil commission.

6.6 Simplifying disclosure

The process through which an adviser provides advice resulting in a customer taking out a policy involves a considerable number of steps:

- Engaging with a potential customer

- Assessing the customer's needs
- Deciding on a suitable product
- Agreeing a level of cover which is affordable
- Completing the application form
- Undergoing underwriting including any medical checks required
- Insurer issuing the policy
- Customer paying the first premium.

There are two types of disclosure, one for the advice provided and the other in respect of the individual providing the advice. Simplifying both has advantages to the consumer.

The advice disclosure document appears to be driven more by the defensiveness of the advisers in protecting their legal position than by the goal of communicating effectively with the customer. Similarly the two disclosure documents currently required of an AFA (the primary and the secondary statements) are multi-page documents. Each of these can be simplified and abbreviated in the interests of clear and succinct communication with the customer.

We note incidentally that under the current regime an RFA is not obliged to provide a statement of advice to a customer and is subject to a very limited disclosure requirement. With the proposal to move to just one designation, AFA, this anomaly will disappear.

Reducing the information required to be provided to a customer will have the advantage of saving costs to the adviser and the insurance industry and can be done at the same time as improving the quality of the information provided. There is universal evidence that the average customer takes limited notice of written information put in front of them particularly where it is compiled over a number of pages. The failure of this full disclosure approach is well documented.

Accordingly the recommendation is:

Recommendation 1E – Simplify the advice and disclosure processes

For this purpose we are recommending that the advisers and insurers work with MBIE to simplify the form and content and method of providing adviser disclosure and with the FMA Appointed Code Committee to develop proposals for a short form advice disclosure statement.

6.7 Product classification and AFA specialisation

There are currently two product classifications Category 1 and Category 2. While an AFA can sell and provide advice on both categories, RFA's are limited to category 2 products which include life insurance and which are considered to be less sophisticated products so not needing the skills of an AFA. If there is only to be one financial adviser classification it follows that product categorisation is not necessary.

A further consideration in this area is to allow specialisation of AFAs. We essentially see three areas of specialisation: saving, borrowing and risk mitigation. Saving is essentially investment orientated, borrowing relates to lending such as mortgages and risk mitigation relates to insurance. An AFA may choose to be qualified in one or more of these areas of specialisation thus advise on one or more of these areas.

6.8 Building an adviser profession for AFAs

One of our policy propositions was that access by consumers to financial advice is important and while recognising the role played by the QFE representatives we also want to enhance the role of the independent financial adviser. The adviser industry has no one professional body. Instead it has a number of bodies which are referred to as adviser associations which are there to promote the interests of the advisers. This is in contrast to a professional body which is in part there to protect the interests of the general public in respect of the activities of a profession.

As noted in section 3 the adviser associations in most instances trace their origins back to a body which represented the interests of the aligned advisers with one of the insurers. To date they have never seen themselves as true professional bodies. However the introduction of the Financial Advisers Act 2008 has generally raised standards of behaviour in the industry and brought in greater regulatory accountability. Accordingly the opportunity exists for the associations to become such professional bodies.

However the evidence suggests that they are some way from being in a position to become professional bodies. But there are encouraging signs of changes and for example the greater level of co-operation between the IFA and PAA indicates that a larger industry body will emerge within a limited time line and this could in time form the basis for a professional association.

Our discussions have involved many advisers who are passionate about the role they play and the value they could add if given the chance. In summary we believe that there are enough advisers out there who want to be part of a well-recognised and respected profession where membership of the profession means something and where the average New Zealander is happy to be actively engaged in seeking the help of a trusted professional financial adviser.

For this change to happen, the current associations must in time become recognised professional bodies. This would be an important positive development which would benefit the life insurance industry as it moves to establishing a well-functioning competitive marketplace. The regulatory framework makes no recognition of the current adviser associations. The current disciplinary framework relies solely on the FMA with no reference to the associations and questions have been raised with us as to how effective the FMA has been in this role to date. We see an opportunity here to involve the associations in the regulatory processes.

Accordingly we make the following additional recommendation to be incorporated into recommendation 1B:

- there is created a new governance process for monitoring and ensuring compliance by AFAs with the AFA Code of Professional Conduct involving both the FMA and the adviser professional associations.

7 Recommendation 2 - Remuneration – Eliminating the conflicts of interest

In this section we explore the current commission levels and the conflicts of interest which exist courtesy of the current remuneration basis to advisers. As set out in the introduction to this report, it is in the adviser distribution channel where we see significant conflicts of interest. Therefore we concentrate on how the current financial incentives are driving adviser behaviour and leading to poor outcomes for the customer and industry.

The levels of commission paid in NZ are higher than overseas – significantly higher. To draw a contrast the recent discussions for major changes in Australia are in response to initial commission levels of 120% of the annual premium, in NZ they can be 200% plus. It can be argued average policy sizes are higher in Australia and this explains the difference. Our view is that may be true in part but it does not alleviate the conflict of interest that arises for advisers.

The concern for the adviser industry is that the level of remuneration paid compromises both the advice given to customers and compromises the placement of the insurance. The level further incentivises the adviser to replace a policy after a short period of time irrespective of the interests of the customer. We have a situation where high commission leads to:

- A high number of policies being unnecessarily replaced
- Unnecessarily high industry costs
- Inappropriate cover for the customer in many cases
- Premiums which are higher than they would otherwise need to be.

If the industry can achieve a better alignment of interest between the customer, the adviser and the insurer then we will have a better industry culture and achieve a sustainable competitive industry.

To date there have been no major calls that have resonated for banning commission or even limiting the commission to a level percentage of premiums with no additional initial payment. Certainly some consumer groups do advocate the banning of commission and it has been considered previously but abandoned because of the fear of making the under insurance problem worse. However it is not hard to envisage this changing. The expectation is that there will be full disclosure in the future of commission paid. Based on the current commission levels it is easy to see the public becoming concerned at the rates and to call for major changes. It is better that the industry looks at these issues now itself. Already there are warning signs with the FMA interested in the commission paid in the industry and in the foreword to the MBIE issues paper, the Hon Paul Goldsmith, raises the issue of commission bans and the issue of conflicts of interest.

New Zealand needs a prosperous adviser industry if the value of insurance is to be widely appreciated and the levels of cover in New Zealand are to rise. There are signs that the adviser industry is in decline with a shrinking share of the new business written as companies look for more cost effective methods of distribution. There will come a tipping point at which adviser distribution ceases to become the benchmark cost for distribution built into premiums and advisers will be forced to a fee for service model to compete. So changes are required and the major area for change is the levels and structure of the commission paid.

Overall, the various questions raised about the practices of life insurance consultants and life insurers themselves have their genesis in the remuneration structure of advisers. Typically, advisers receive, on both new and replacement policies –

- an initial commission of 1.8 to 2 times the annual premium

frequently supplemented by –

- various forms of override commission or incentives that raise the level to 2.3 times, and
- awards such as overseas trips and other “soft dollar” benefits.

Illustrating the above for a typical policy sold by an adviser the annual premium is \$1,500 per annum and the initial commission amounts to \$3,000.

7.1 Basis for high remuneration

Historically life insurance policies were, with some exceptions, seen by customers as long term contracts with consequently high value to the insurer. Accordingly high commission/initial costs could be accommodated over the term of the policy.

While it was the outsourcing by the insurers that highlighted these high costs they have been present in the industry for some time albeit not at the current high levels. But the change in the mix of products over the last 20 years has seen a new landscape and made the costs unsustainable. We now have a landscape of:

- Regular changes to product benefits on offer;
- Products with built in increases in premiums giving rise to potential questions each year from customers on whether the new premium for their policy still represents a good deal;
- The increased ability of advisers to compare products through online quoting tools.

In these circumstances advisers bear no risk, and in fact benefit, from adding cost to the industry by finding any reason to move customers to a new policy when in fact it is not economically sensible for customers to change policies.

If we put this together with the built in incentives to advisers to switch their customers to a new policy and receive a new initial commission of 200% of the premium we have a situation which the industry is unable to address and warrants regulatory intervention.

7.2 Adverse implications of high commissions

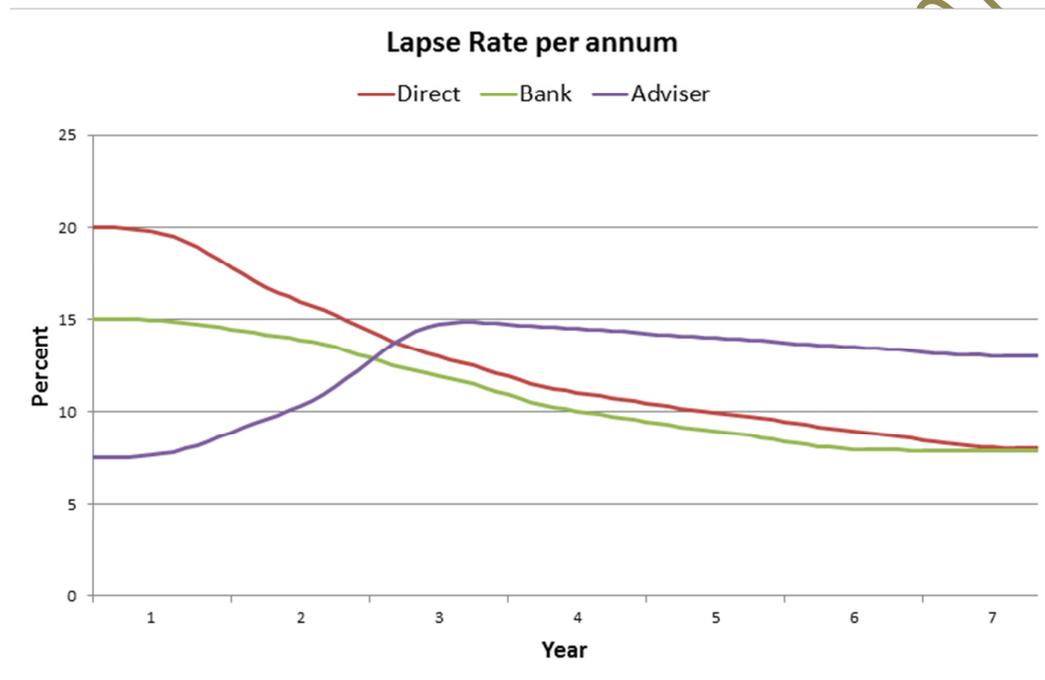
The adverse implications of these high initial commissions are profound -

- Much of the marketing and sales strategies of insurers are aimed at advisers rather than consumers. To illustrate we see very little direct advertising by insurers. Advertising which was well directed and undertaken by a series of individual insurers could increase the size of the whole industry.
- The cost of adviser distribution sets the benchmark for acquisition costs in the industry. One of the consequences of that is that companies that operate without advisers charge similar prices to the adviser-based insurers but with much lower expense rates. As a result they make additional profits rather than passing on the benefits of their lower expense rates to their customers. A second consequence is that while some insurers now sell their products on the internet there has been no move by any insurer to make serious inroads using this channel because of the spectre of channel conflict – having advisers turn against you for promoting other sales channels.
- The lack of competitive pressures in the industry is made worse by the small size of the group life market in New Zealand.

- There is limited customer-oriented innovation or development within the industry, in contrast to various other industries where customer relationship management and genuine customer orientation are regularly upgraded to deliver efficiencies and improved services to customers over time.
- It makes it difficult for adviser based insurers to diversify their distribution channels.

7.3 High lapses and replacement policies

The analysis of the lapse rate data supplied by the insurers show very different pictures for each of the three distribution channels as shown in the graph below (annual renewable business).



The graph highlights the differing pattern of policy lapsation across the three sales channels. Both Direct and Bank exhibit a similar shape of policy lapse: a rate that starts higher and declines over time to a consistent and similar long term rate of lapse.

The Adviser curve has a distinctly different shape: it starts low, rises to a peak in the third year and then declines to a stable rate that is distinctly higher than for both Direct and Bank. The jump in year 3 corresponds to the end of the commission clawback period and indicates adviser-based policy replacement at that point. The commission clawback period is the period during which, if a policy lapses, some or all of the initial commission is claimed back by the insurer from the financial adviser.

Alternatively advisers are suppressing or deferring lapses for poorly sold business in the first two years to avoid commission clawbacks and then there is an elevated rate of lapses for a period while these policies leave the system. The truth is probably a combination of both. However the higher long term lapse rate as compared to Direct and Bank points to an ongoing level of replacement policy activity and is consistent with the replacement business statistics quoted above.

While not shown the lapse rates for the level premium policies are different again with a steady constant lapse rate of less than 10%.

A certain level of replacement policy activity will and should occur with some driven by customer choice. This is healthy when customers' needs change and new policies better suit their needs; it promotes competition between insurers and leads to better outcomes for customers. Inappropriate policy replacement, however, adds cost to the industry and can be to the detriment of customers if they have a claim declined as a result of the policy replacement.

The data supplied to us and comments to us in our discussions suggest that the level of replacement business for advisers is between 40% and 50% of all new policies sold by advisers.

The statistics illustrated in chapter 3 above show that, while we see a healthy growth in new business, we also have a large number of policies being lapsed. We have discussed in the section "Basis for high remuneration" the landscape in the industry with products designed for a shorter expected shelf life. We talked of how it is easy for the adviser to demonstrate why a policy should be replaced.

Our analysis, from examining the effect of reduced lapses rates, indicates inappropriate policy replacement activity adds 10% to 15% to industry costs. In a \$1b industry (annual life risk premium) this equates to over \$100m every year in excess cost to customers and to the economy of New Zealand. It is expected that with lower premiums personal risk insurance uptake could be higher than it is now and this would assist in reducing the under insurance problem in New Zealand.

The future of the adviser industry is threatened by the payment of high commission for policies sold for short periods of time. It is unsustainable. Changing the commission basis and stopping incentivising this behaviour is necessary for the industry. It will also encourage the insurers to make more durable products.

7.4 First mover disadvantage

One may ask why insurers pay such high commissions and, if they are dissatisfied with the levels why they do not simply reduce them? The answer is the same all around the world and it is in two parts. Firstly, most insurers are heavily dependent on advisers for their business volumes, so they seek the loyalty of advisers by increasing their remuneration levels until some form of market equilibrium is established. Secondly, having found the equilibrium, no single insurer can pull back from this position without compromising its market position and sacrificing its business.

In short, the insurers are beholden to the advisers as a whole, and the interests of consumers are subjugated to the interests of the advisers.

7.5 Will customers pay for advice?

Before discussing the remuneration levels for advisers we need to reaffirm why we have commission payments.

All the evidence suggests that divorcing the payment for advice from the sale of a specific product is difficult for life insurance. The contrast is for investments where the customer has a specific sum to invest and where a deduction can easily be made to pay for the advice. For life insurance we are looking at a series of regular payments and there is no sum readily available to pay for the upfront advice, particularly in the case of the younger customer. An important proposition of this review is to grow the total market and to assist the younger customer to realise the value life insurance cover can deliver.

As a consequence we are left with the insurer selling the product having to fund the party making the sale, with or without advice.

We believe more emphasis should be placed on giving the customer the option to meet the cost up front with a separate payment. This can be very attractive in some cases. To illustrate for one insurer, if the adviser chooses not to receive commission the premium is reduced by 35%. If applied to an annual premium policy of \$2,500 the premium reduces to \$1,625 per annum. Over 10 years this represents a saving of \$8,750 assuming a level premium. With an age related premium basis the saving is greater. For the companies where we checked the reduction is 25% or more.

7.6 Structure of the commission

Above we noted that the average policyholder is not going to be able to afford or be willing to pay for advice and that the adviser will be remunerated by commission paid by the insurer. While the idea of a level commission structure is attractive it does not match to the costs incurred by the adviser for finding the customer and the advice and placement process they need to go through.

Accordingly the initial remuneration needs to be set at a higher level than the servicing commission that follows. The question is how much higher? What are the costs involved to the adviser? And is it appropriate for all such costs to be met on policy inception? Currently we have an unusual structure where the level is set to reimburse the adviser for all the costs involved. A more usual business model would see a part contribution to costs from a new customer with an on-going contribution from that point on.

In considering the level we want to be mindful of the potential conflict of interest arising and the other distribution channels within the industry. Too high a level will see the incentive to write replacement business continue. Considering other distribution channels we see that the banks which focus solely on distributing through their internal channels are more profitable. The results of our data analysis suggest that these channels are considerably more profitable than the adviser distribution channel.

So the economics of the industry dictate that the initial commission level for a sustainable industry needs to be lower than is currently the case, while still providing for higher initial levels as opposed to a level commission with no additional initial payment.

7.7 Varying the basis on which to pay the commission

The need for the adviser to be paid on a commission basis related to the level of the premium is accepted but it raises a number of questions, two of which are:

- How the basis fares for differing premium levels; and
- Is there an argument to cap the commission where a high premium is payable?

The review is looking to improve the life insurance coverage in New Zealand and wants to contribute to ensuring there are sufficient incentives in place for advisers to grow the market. Reducing the current initial commission levels will raise the question of whether people able to afford limited premiums will be properly reached by the adviser channel in the future. To illustrate a policy with a premium of \$750 per annum will, with say a 100% initial commission rate, provides a payment to the adviser of \$750, compared to the current \$1,500. Is this economic for the adviser? This is not an easy question to answer instead we make the following observations:

- There is evidence that the banks are successfully reaching the customers paying lower premiums. The data we received showed an average bank annual premium of around \$700 compared to an adviser premium of \$1,500.

- The misalignment of interests that currently exist and drive poor behaviour and outcomes apply at all levels of premiums and need addressing.

Should we cap the commission for higher premiums? We have come across cases where the dollar level of the initial commission has been very high and well above any reasonable assessment of the costs of the advice. Proper disclosure may work to correct this in the future however we believe a limit should be adopted to protect the customer.

A point to note here is that the recommendations leave it open for an adviser to agree with the customer the payment of a separate additional fee.

7.8 Commission on replacement policies

We noted above the high lapse rates for policies sold through the adviser channels and the fact that 40% to 50% of new business is replacement business. It is easy to see why we have this situation with the high initial commission rates and the ability to easily demonstrate how a new policy can provide some benefit to the customer, even if it is relatively trivial. But it is damaging to the industry overall and of questionable benefit to customers leading to greater overall costs and higher overall premiums to all customers.

The best way to tackle this while enhancing the overall servicing role of the adviser is to change the remuneration basis and cease the payment of new commission for replacement policies. This will take away the financial incentive which is driving this behaviour.

Where a customer chooses to increase their premium above the current premium this needs to be recognised and initial commission payable on the additional premium. In regard to the previous premium level, servicing commission would be payable.

7.9 Period after a further initial commission can be paid

Immediately above we discussed the issues regarding replacement policies. We want to both protect the customer from the risks involved and reduce the costs that arise to the industry from unnecessary policy replacement. At the same time we want to ensure customers receive comprehensive advice from time to time on their financial needs. Such advice is more than the regular servicing expected from an adviser to an existing customer. This comprehensive advice requires the adviser to spend sufficient time working with their customer. The adviser should be properly remunerated for this role. We therefore need to enable the adviser to receive another initial commission payment. The question is how often should this be? We have settled on 7 years. The idea was put to us that a review with a further additional initial commission payable could be triggered by a life event such as a marriage or a new child. However the issue of how to police such a rule is seen as insurmountable.

We note here that if the insurers start to take a pro-active stance of continually updating their policies the need for any major review by the adviser is lessened.

The incentive of completing a comprehensive review for the customer after this agreed period should help incentivise the advisers to stay in regular contact with their customers over the period.

7.10 Renewal commissions

The current renewal commission levels are low. From the data we received the average levels were between 7.5% and 10% of the annual premium.

The sale of a life insurance policy can be viewed either as a transactional event or the beginning of an advisory relationship. We want the industry to move to a position where providing advice is not seen as a one off transaction but rather the start of an on-going relationship beneficial to both the customer and the adviser. The renewal commission level has to be set to achieve this. There is also the balance that it needs to increase to offset the recommended reduction in the initial commission level. The aim is to not only to ensure incentivise regular professional customer support but also build up the adviser industry and provide the well performing adviser with a revenue stream to maintain a sustainable business.

We are trying to establish a structure to move advisers to a more service orientated business model to maintain customer relationships and amend existing policies for customers as their needs evolve (rather than replace). We are seeking to remove the incentive to write a new policy anytime something changes which adds risk for customers and cost to the industry.

One can mount an argument that the reduced upfront commission proposed for advisers will mean advisers do not receive full recompense for the advice process from the initial commission they receive. Therefore there will be an element of deferred remuneration in the renewal commission they receive. If the initial commission is less than the cost of the advice process there is an increased incentive to continue to maintain the client relationship and to service the client well.

An element of deferred remuneration in the renewal commission received suggests the adviser should be guaranteed that stream of renewal commission for a period until recovery of the cost of the initial advice is complete – therefore they should receive a property right associated to the renewal commission stream.

The alternative view is that the renewal commission is paid to the adviser to service the client and if the client wishes to change adviser the client should be able to redirect the renewal commission to the new adviser. This saves the new adviser from having to put a new policy in place to receive recompense for servicing that client and maintains the character of the renewal commission, namely to meet the costs of servicing the client.

If one believes the renewal commission is to recompense for servicing the customer, the customers should be able to redirect the servicing commission to whoever they wish to be their servicing adviser.

Our position is that renewal commission is a servicing commission and we should refer to it as that. The reason is as stated earlier – we are trying to move advisers to a more service orientated business model to maintain customer relationships and amend existing policies for customers as their needs evolve (rather than replace their policies).

The proposed level of servicing commission might result in advisers being over compensated for servicing the client and they will recoup some of their initial expenses incurred in selling the policy. To achieve that outcome they will have to service the client satisfactorily. This servicing relationship needs to be strong enough to survive “commission rebate companies” that try to arbitrage that relationship. It should be that the servicing agent relationship is valued by the customer enough to withstand these threats to it.

At present renewal commissions are treated as a property right in most instances. The loss of a property right will diminish the value of an adviser business available for sale. From the sellers perspective that fits with our belief that it is servicing commission and advisers shouldn't be able to sit idly by being paid for doing nothing. From the buyers perspective our response is if you buy it to genuinely service it, it is more valuable to you. This creates the correct price signals whereas under the current regime the portfolio is worth the most to the adviser who can write replacement policies the most quickly. The absence of initial commission on replacement business will mitigate that risk. Companies are currently forced to buy back portfolios to avoid the policies being replaced.

7.11 Clawback

Claw back is the mechanism by which an insurer tries to control its exposure to high initial commission and policies cancelling. It is alternatively known as the “commission responsibility period”.

When commission exceeds the annual premium there is an incentive to put in place policies that the adviser knows will be of limited duration. In fact there have been cases of advisers paying the premiums themselves to access the initial commission. This can act like a Ponzi scheme if volumes increase.

The approach adopted by insurers is that a policy must be in force for a full 2 years for the adviser to receive the full amount of the commission. If the policy cancels prior to that the initial commission paid is “clawed back”. The scale is progressive over the 2 year period. In our data received from insurers 2 years was the universal period beyond which initial commission was deemed “fully earned”.

Our view is that the initial commission clawback period should remain at 2 years. Consideration was given to extending this period but given the recommendation to reduce initial commission and that policies can cancel for reasons outside of the advisers’ control we have maintained the 2 year period.

7.12 Volume incentives and soft dollars

We are looking to change behaviour and improve the culture in the industry by aligning the interests of the three parties, the customer, the adviser and the insurer. There is widespread concern over the role played by volume incentives on personnel involved in making sales and whether the incentives lead to poor outcomes for customers. This was the subject in the FSA paper referred to in chapter 2 of this report.

We fail to see any justification from a customer’s point of view of the adviser being paid for selling more policies – which is what a volume bonus encourages. It is a volume bonus not a quality bonus despite often being referred to as that. A premise of this report is that we accept payment of commission due to the inability of fee for service to adequately operate. We view being remunerated for selling an individual policy by commission as acceptable under the circumstances but do not see this argument being extended to being paid extra if you sell more of the same. To permit it creates an additional conflict of interest.

It can be argued volume bonuses apply equally in the Bancassurance setting – the bank representative has just as much incentive to sell to ensure they receive their “quarterly” bonus. A distinction can be drawn however. The bank representative will likely have a performance pay component that relates to activity versus an independent adviser who is already heavily incentivised to sell. Incentivising the adviser to sell more of the same is not the same as motivating a salaried individual into activity. There is likely to be a matter of materiality as well – the amount on offer to the agent will be significantly higher.

Continuing the last point there is similarly a concern over the other non-commission incentive payments (known as “soft dollars”) made to advisers. These concerns are in addition to the concern with the cost of these payments. A key item here is the overseas trips offered annually by the insurers to their “top” advisers as measured by volume of business sold.

Our recommendation is that all volume based incentives, either in cash or kind, should be banned.

7.13 Recommendations

The recommendation is twofold –

- to specify a future new model for adviser remuneration that minimises conflicts of interest and promotes the regular servicing of clients; and
- to describe a progressive transition from current arrangements to the new model.

Recommendation 2A - a new remuneration model

The new remuneration model for advisers has lower initial commissions but higher renewal commissions than is common practice today. We rename renewal commission servicing commission to better reflect its role. Note that our recommendations relate explicitly to maximum commissions payable. There is no obligation on any insurer or adviser to use the maximum commission rates

The recommended new model is -

- **servicing (renewal) commissions** of a maximum of 20% of premiums (instead of, as is common practice today, 7½% to 10%) payable to the adviser nominated by the customer as the adviser currently servicing the customer
- **initial commissions** (which today are commonly 180% to 200% of the first year's premium for all new policies, whether for first time policyholders or for replacement policies of existing policyholders) –
- for policies written for new customers (i.e., consumers who have no life insurance policies in force): an initial commission not exceeding 70% comprising a 50% initial payment and 20% servicing commission. A cap on the total commission payable would apply based on a premium of \$5,000.
- for replacement policies written for existing customers (i.e., consumers who already have one or more life insurance policies in force) within seven years of inception of any existing policy: no initial commission unless the premiums are higher, in which case an additional commission not exceeding 50% of the premium increase is payable.
- Volume-based incentives, in cash or in kind, to be banned. Fee-for-service is to be encouraged (and, as noted in the recommended disclosure arrangements for financial advisers, nil commission premiums are to be disclosed at all times, even when a commission is payable).

A cap on the dollar amount of commission payable has been included as a way to avoid substantial conflicts of interest in absolute dollar terms recognising that at this level of premium the customer should be encouraged to pay separately for advice on a fee for service basis.

As noted above the commissions stated are maximum commissions. It may be that to support dealer groups (who traditionally have been funded from volume based incentives) advisers will direct some of their commission to their chosen dealer group. For example the servicing commission of 20% could be split 15% to the adviser and 5% to the dealer group.

Where life insurance policies are sold by a QFE representative, those policies are part of the sales process but not an advice process. Nevertheless, the representative is still expected to complete a needs analysis and accordingly it is recommended that in those cases the same remuneration arrangements as for AFAs will apply, including initial commissions. In cases, however, where the customer asks for an execution-only transaction and forgoes any advice or needs analysis, there would be no initial payment made, so that the maximum commissions are level commissions of 20% of premiums.

Hence we are recommending that, for policies sold by QFE's, the same arrangements apply as for AFAs unless it is an execution-only transaction, in which case no initial commissions would be payable.

Recommendation 2B - transition to the new model

It is acknowledged that the existing business models of advisers and adviser groups are built around existing remuneration arrangements. Since the recommended new model involves a substantial reduction in initial remuneration and a different cash flow for advisers, there needs to be a transition process that will enable advisers and adviser groups to rework their business models and to adapt to different remuneration and cash flow arrangements.

There are several ways of designing a transition arrangement. The recommendations require changes in the regulatory framework and there is likely to be an announcement date, for example, middle of 2016, and a commencement date for the transition phase of some later time, perhaps during 2017.

We are recommending that the transition process be along the following lines –

- from announcement date, all the volume-based incentives to be removed or cancelled (any grandfathering arrangements would be limited) and no new ones introduced
- from commencement date, at the adviser's discretion EITHER maximum renewal commissions of 10% and maximum initial payments of 130%, to give total maximum initial commissions of 140% of the first year's premium OR maximum renewal commissions of 20% and maximum initial payments of 80%, to give total maximum initial commissions of 100% of the first year's premium
- from two years after commencement date, the 10%/130% option to cease to yield maximum renewal commissions of 20% and maximum initial payments of 80%, to give total maximum initial commissions of 100% of the first year's premium
- from three years after commencement date, the new model to come into play, with maximum servicing commissions of 20% and maximum initial payments of 50%, to give a total maximum initial commission of 70% of the first year's premium.
- The payment of the commission is limited to the first \$5,000 of premium (per life insured).

Regarding replacement policies, we are proposing the same arrangement as under the new remuneration model, i.e. no transition arrangements for replacement policies. Hence *we are recommending that, where a policy is replaced within 7 years of its commencement date, no initial commission be payable, with payments being limited to servicing commission*

8 Recommendation 3 – A new process when a replacement policy is recommended

For adviser based business it is accepted that 40% to 50% of new business is replacement business. Other recommendations in this report will operate to limit inappropriate policy replacement. However it is important that customers are protected when it is recommended to them that a new policy would better meet their needs. We are essentially recommending the transferring of some of the risk on policy replacement from customers back onto insurers and consultants.

We envisage three forces operating to ensure replacement policies issued are appropriate:

- The financial incentive for inappropriate policy replacement is reduced by virtue of the recommendation on remuneration in recommendation 2;
- The industry adopting a more pro-active approach to maintaining legacy products and enthusiastically facilitating updates to existing policies;
- The industry applying a defined policy replacement process.

8.1 Product design – maintaining legacy products

In section 3 we outlined how the landscape of the industry had changed from long term policies to regular product updates. This is most apparent in the growth in the trauma products and the increase in the covered conditions. New trauma definitions get introduced frequently with the definitions of the new benefits “improved” compared to the old; the revisions made to policy wordings often increasing the likelihood of payment. A driver for these changes is considered not to be for the benefit of the customer but to provide the opportunity for the advisers to go and talk to their existing customers about replacing their current policy with one from a new insurer. To deal with these issues we believe there should be passing back of beneficial policy upgrades by insurers.

The predominance of age rated premiums which change each year increases the opportunity for an adviser to review a customer’s existing policy. The adviser needs to demonstrate the value of the new replacement product and this is facilitated by the rise of the product comparison websites as discussed in section 3. We believe insurers should be more open to policy updates to avoid having to replace policies.

8.2 Policies are re priced each year

The standard policy, the annually renewable policy, does not have any premium guarantees on the future rates to the customer and the insurer has the opportunity to re price annually. Instead of issuing a new series of policies with the updated features it would be better to introduce the features to the existing policies. This already happens to some extent. There is a need to manage the underwriting issues but there are accepted ways to achieve this. Premium rate structures should be maintained so it is not necessary to move to a new policy to access a new and cheaper premium rate structure.

The health insurance industry takes this approach and it is a fully established and accepted practice.

8.3 Attempt in 2012 to resolve issue

In 2012 the insurers agreed a formal process to ensure that customers were properly aware of the comparative benefits when a replacement policy was being considered to enable them to make an informed choice; the key issue being the cover provided under the new policy matched that of the original policy. The worst outcome is that the customer had developed a medical condition that would not be covered under the new policy. The process set up involved ensuring:

- The customer understood the possible implications of replacing the existing policy and switching to the new one;
- The consultant had discussed all the risks with the customer.

It was a voluntary system which failed to work as not all members adopted the approach.

We note that in Australia they also tried unsuccessfully in 2012 to deal with just the replacement policy issue separate to the remuneration issue and the approach failed.

So to reiterate the points made at the start of this section a 3 pronged approach is required to reduce inappropriate policy replacement:

- Revise the remuneration basis to reduce the financial incentive;
- The industry to move to a basis where legacy products are maintained and updates to existing policies are facilitated, and
- A defined policy replacement process to be put in place.

The above three measures together will deliver on-going value to consumers.

8.4 Protecting the customer

The industry is concerned that when a customer chooses to lapse their policy they are foregoing the benefits their existing policy provides. The insurer will chase the customer to ascertain why. In the case of the policy being replaced by another policy issued by the same company these issues can be managed by the insurer. But in most instances the replacement policy will be with another insurer.

It is important to accept that there are many legitimate reasons for a customer to change an existing policy and any process set up must not impede this. The recommendations in the previous section included the ability of the customer to decide who will service them and so who receives the renewal commission. The new adviser may be in a position to reassess the customer's needs and arrange additional cover involving an additional premium. In this case there will be some further commission payable. But we need a defined agreed process to deliver the due protection to the customer.

8.5 New process

The outline of the proposed process is as set out in the following paragraphs. The application form will include the following:

- A question in a prominent place: "Is this policy intended to replace existing insurance? If yes, do not cancel your existing policy until you have received the new policy document and you are happy with it."

- Followed by a further question: “Are you replacing your existing policy because it has been recommended to you to do so?”

A no answer to that question implies the replacement policy is being effected because of customer choice. In that circumstance no special replacement policy process need be followed.

If the answer is yes, then a replacement policy process similar to the following is to apply:

- The consultant will need to obtain a copy of the existing policy document and advise the customer on the differences between the two policies.
- The consultant will provide the following undertakings to the insurer:
 1. This new policy has been sold as a replacement for an existing policy held by the customer.
 2. I have reviewed and compared the policy terms of the existing and new policy, considered the current circumstances of the customer, and certify that replacing the existing policy is in the best interests of the customer.
 3. The reason for recommending a new policy is ... [box available for answer to filled in]
 4. I have explained the benefits provided by the existing policy to the customer and the new benefits provided by the new policy. The customer fully understands these differences and has signed a statement acknowledging and accepting these differences.
 5. I have made due enquiry and discussed with the customer the current state of their health and the position stated on the application form is correct to the best of my knowledge.
 6. The increase in the premium annual premium payable over the next 12 months is \$...

A copy of this advice will be provided to the customer. As a matter of course the adviser will disclose the remuneration they stand to receive under the existing and replacement policies under our earlier recommendations.

To protect the interests of the customer and provide the customer with continuous cover the insurer will need to:

- Waive any waiting periods under the new policy.
- Waive any adverse consequences arising should the customer misstate their true medical condition at the time of the application unless it was substantially incorrect, material and done fraudulently.

8.6 Recommendation

Our recommendation is as follows:

Recommendation 3 – Introduce an industry wide replacement policy process

The process should be one that provides assurances to the new insurer and protection to the customer. In particular, because there may be risk of inadvertent non-disclosure when a claim occurs and of a possible claim during any stand down period, the new insurer would be required to provide cover should these events occur.

Therefore we are recommending that the insurers under the auspices of the FMA put in place a structured policy replacement process to protect customers.

9 Recommendations 4 to 7

This section covers recommendations 4 to 7.

9.1 Need for market conduct regulator for the life insurance industry

To date the life insurance industry has been subject solely to regulation for solvency purposes, with the RBNZ operating as the prudential regulator. In contrast to other jurisdictions there is no body charged with the role of market conduct regulator for life insurers. A more typical overseas approach is followed in Australia where a life insurer would be subject to regulation by both ASIC, as the market conduct regulator and APRA as the prudential regulator. Their roles are defined below:

ASIC's role is to "contribute to Australia's economic reputation and wellbeing by ensuring that Australia's financial markets are fair and transparent, supported by confident and informed investors and consumers."

APRA's role as encapsulated by their mission statement "is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system."

The ASIC role is similar to that of the FMA's role in NZ.

The FMA was established in 2011 under the Financial Markets Authority Act 2011 with the main objective of "promoting and facilitating the development of fair, efficient, and transparent financial markets". The key FMA function is "to promote the confident and informed participation of businesses, investors and consumers in the financial markets".

The life insurance industry was left outside the scope of the Act when it was introduced in 2011. In its current market regulator role the FMA has a series of established mechanisms it uses to achieve its goal of improving an industry's market conduct. As noted in a recent speech in Brisbane by the FMA chief executive the FMA is not looking to pursue legal cases against parties but looking to apply other approaches to improve market conduct. Two examples are:

- conditions which the FMA would apply when granting an insurer a licence
- standards and guidance notes on industry practices.

Of interest the recent section 25 request from the FMA to the life insurers was for information in respect of advisers and made in the context of its role as market regulators of financial advisers. The request was not in regard to the behaviour of the life insurers.

The report has highlighted a number of important areas where parties in the industry could be perceived to be acting poorly. For example companies encouraging advisers to move blocks of business which implicitly endorses policy replacement to advisers without individual consideration of the affected customers.

This report is about facilitating and bringing about changes to the life industry with the goal of achieving a well-functioning competitive market place and to deliver corresponding benefits to customers. The industry for competitive reasons is unable to make these changes itself and so requires a market conduct regulator.

Recommendation 4 – FMA to become the market conduct regulator for the life insurance industry

We are therefore recommending that the life insurance industry become the subject of market conduct regulation and that the market regulator be the FMA.

This will require the government to legislate so that the FMA can become the market conduct regulator for the personal insurance industry.

9.2 Need for an agreed Code of Practice

The industry does not currently have a code of practice. This is in contrast to codes adopted by the NZ banking and general insurance industries.

The Insurance Council of New Zealand (ICNZ), the general insurance industry body, has recently adopted a new code known as the “Fair Insurance Code 2016” which comes into effect on 1 January 2016. The main features of the code comprise:

- Minimum service standards for insurers regarding processing of applications, responding to claims, renewing existing policies and introducing more easily understood policy wordings.
- The responsibilities of each party i.e. the insurer, the broker and the customer.
- Raising the level of professionalism in the industry in its treatment of customers.
- An obligation on all members of the ICNZ to comply with the code.

A code was first introduced in 1993 and is reviewed every three years, with the extent of the review depending on circumstances. The recent code changes will be partly in response to the difficulties the industry has faced responding to the high expectations of homeowners adversely impacted by the Canterbury earthquakes. It is a clear statement by the industry that it will listen to its customers to ensure that the policies they buy meet the community needs and expectations.

The code covers all general insurance products and by definition thereby excludes life and health insurance. The overall aim of the code is to raise the behaviour standards within the industry for the benefit of the customer.

Our investigations have revealed a number of shortcomings and potential areas of improvement in the practices of life insurers. They can be seen to arise largely from the emphasis that insurers place on satisfying advisers rather than customers and are exacerbated by the conflicts of interest inherent in current commission arrangements. If the industry can get to a position where the conflicts which arise from the high initial commissions have been addressed then it will be better placed to work together on industry issues.

The life insurance industry has previously had a code of practice but divisions within the industry have made on-going agreement on a code difficult. Nevertheless we believe it is appropriate for the industry to restart efforts to develop a code of practice and to do so in consultation with the FMA, adviser associations and consumer representatives.

Recommendation 5 The life insurance industry to adopt an agreed Code of Practice

Accordingly we are recommending that the life insurance industry under the auspices of the FMA develop a consumer-oriented code of practice and that in the first instance it be modelled on the General Insurance Fair Insurance Code.

9.3 Progress review of industry transformation 4 years after new regime implemented

The aim of the report is to feed the recommendations into the MBIE review of the Financial Advisers Act 2008 initiated by their Issues Paper dated May 2015. The response by MBIE to the submissions made is due later in 2015. A timetable for legislative changes will possibly see the Government's response in the middle of 2016 and on the basis that the recommendations find their way into a bill in response to the MBIE review of the Financial Advisers Act, the recommendations are unlikely to be enacted till early 2017 at the earliest.

It is very much the aim of the recommendations made in the report that it will lead to changes in the NZ life insurance industry. These changes are intended to be transformational for the industry, changing the face of competition, the industry structure and most importantly delivering real consumer benefits.

The full consequences of such changes cannot be foreseen in advance and as a result we recommend a full review is completed once the changes have been introduced to assess their effects.

Recommendation 6 A progress review of industry transformation in 2020

Based on our assessment of the timetable for change we are recommending that a review of all changes made as a result of these recommendations be undertaken in 2020.

The aim of the review would be to assess progress towards a well-functioning competitive market place for life insurance with corresponding benefits to customers and, to the extent necessary, to revise the arrangements then in force.

9.4 KiwiSaver able to purchase life insurance cover

The level of life insurance coverage in New Zealand is low compared to most developed countries. The chart in chapter 3 showed that, on a per capita basis for the countries illustrated, NZ was second to bottom. There is evidence that new distribution methods are reaching new customers although the issue that insurance seems to need to be sold as it is not bought acts to limit the reach of life insurance to new customers.

A recent example of a new distribution approach is a scheme by a KiwiSaver provider to offer a life insurance arrangement to their KiwiSaver scheme members whereby the temporary disability benefit is paid to their KiwiSaver scheme. The policy will pay contributions to the members KiwiSaver scheme for 6 months in the event of temporary disability.

A general observation on the operation of the life insurance market can be made here. For self-employed people, adviser distribution dominates because self-employed people will likely have a "broker" relationship for the other forms of insurance they need. Bancassurance is more dominant in the younger age groups and increasingly so in the homeowners group as banks are dealing with their customers at this stage in their life when their life insurance need crystallises. In other countries group life schemes also play a key part for employees. In New Zealand the prevalence of group insurance is much less which is a consequence of our superannuation arrangements.

The New Zealand market has some employer-based group life schemes, primarily left over from when employers sponsored superannuation schemes for their staff. Historically superannuation schemes provided group life insurance cover to scheme members, which still is the norm in the rest of the world. These schemes have declined since superannuation lost its tax preferred status and, to a large degree, one can say the superannuation schemes have been replaced by KiwiSaver. The current number of group life schemes is low, albeit that there is evidence that the interest level

is growing again with some recent high profile employers launching new schemes. The benefits to employees are low premium rates with minimal underwriting because of low distribution costs and the group nature of the scheme.

We believe one way to address this low penetration of group life schemes, and New Zealand's under insurance problem, is to allow KiwiSaver members to use a portion of their annual contributions to pay for life insurance cover. The cover would be made available by the scheme and would be on a group basis negotiated directly between scheme and insurer. It would need to be provided for individual savers as a standard offering where the individual chose to opt in. Not only would such protection be valuable for the community but it would generate a greater public awareness of life insurance and its benefits. Further one can argue that there is little point in saving for your retirement if you are going to die before it. Therefore spreading the cost of basic life insurance benefits amongst superannuation scheme members makes sense on that basis.

A KiwiSaver group life arrangement would stand outside the standard individualised adviser-based practice that currently dominates the industry. It would not replace the need for individual advice and tailored types and levels of cover provided through consultants. It could become, however, a valuable standardised minimum level of protection across the community.

Recommendation 7 KiwiSaver investors to be able to purchase life insurance cover.

On this basis we are recommending that KiwiSaver members be able to use a portion of their annual contributions to pay for group life insurance cover made available through their KiwiSaver fund once contribution levels have risen to a level able to sustain it.

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Review of Retail Life Insurance Advice

Appendices

argoed until 5am 23 November 2015



MELVILLE JESSUP WEAVER

Towers Watson Alliance Partner

A Terms of Reference for report

Objective

The objective of the report is to respond to:

- Issues raised in chapter 6 of the Issues Paper issued by MBIE as part of the FAA review;
- Paragraph 15 of the section 25 request to the insurers by the FMA.

The report is specifically to address the cost of “churning” to the public of New Zealand, the impact of high commissions and identify solutions including a transition path likely to have wide support amongst stakeholders.

The report should consider recent developments in Australia including the Trowbridge Report.

Scope

The report must address:

- The inherent conflicts of interest that exist between insurers, advisers (and adviser groups) and customers;
- The need for commissions and other remuneration for advisers if under-insurance is to be addressed;
- The impact of high initial commissions to insurers and customers including solvency and premium level impacts;
- The role of advisers and their requirement for remuneration;
- The impact of churning to insurers and customers including Bank sales practices;
- Potential solutions to these problems including possible regulatory responses and market solutions and any transitional requirements.

The report should be peer reviewed by John Trowbridge.

Timing

The report needs to be complete by the end of August 2015 and an early indication of likely potential solutions to be proposed will be needed by mid-July 2015.

Engagement with industry participants

It is expected MJW will liaise with industry including product providers, distributors, advisers and advisor groups in the development of the report.

Addendum to the Terms of Reference

Addendum to the Terms of Reference for the FSC sponsored, Melville Jessup Weaver, Report into Retail Life Insurance Advice in New Zealand

1. The FSC member companies have reviewed the MJW Draft Review of Retail Life Insurance Advice and have formed the view that the scope of the report and the weighting given to specific aspects of the Life Insurance Industry are not consistent with the intentions of the FSC in commissioning the report.
2. The FSC members agree that their intention for the scope of the report is that it be focussed on:
 - The current impact to the consumer of replacement advice – both positive and negative; and
 - The current impact to the industry of replacement advice; and
 - The current role of the insurers in replacement advice; and
 - The current advice conflicts involved in replacement advice – across all distribution channels, including all remuneration structures; and
 - Recommendations of solutions that are applicable across all distribution channels, are designed to protect the consumer from the negative impact of replacement advice whilst retaining the positive impacts of that advice, and will drive increased volumes of new business (i.e. reduce the underinsurance gap); and
 - The estimated future impact of those recommendations on:
 - Replacement business rates;
 - Industry new business production;
 - Premium pricing for consumers;
 - Consumer confidence in the industry;
 - Industry lapse rates;
 - Industry profitability;
 - Adviser profitability taking into account remuneration and costs; and
 - Adviser numbers across each distribution channel
3. FSC members also disputed the accuracy of a number of the statements in the draft report including product and pricing competition in the market and the interpretation of claims vs commission ratio for a new insurer which significantly misrepresents the issue.

B List of parties consulted

Adviser Professional bodies:

Institute of Financial Advisers
Professional Advisers Association
New Zealand Financial Advisers' Association
We met with members of SIFA

Adviser groups:

Kepa
Newpark

Insurers:

AIA New Zealand
AMP Life Limited (including The National Mutual Life Association of Australasia Limited)
Asteron Life Limited
BNZ Life Insurance Ltd
Cigna Life Insurance New Zealand Limited
Fidelity Life Assurance Company
OnePath Life (NZ) Limited (part of the ANZ group)
Partners Life Limited
Pinnacle Life Limited
Sovereign Assurance Company Limited
Westpac Life-NZ-Limited

Government agencies:

Commission for Financial Capability
Financial Markets Authority (FMA)
Ministry of Business, Innovation and Employment (MBIE)
Reserve Bank of New Zealand (RBNZ)

Others

We spoke with individual advisers, consultants to advisers, including those offering product comparison tools. We met with consumer groups including Consumer NZ.

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C Documents/reports reviewed

The Australian Financial System Inquiry Final Report (Murray Report) and the government response to it

ASIC Report 413 “Review of retail life insurance advice”

The Life Insurance Advice Working Group (LIAWG) Report, the “Trowbridge Report”

Financial Service Authority (FSA) “Guidance Consultation – Risks to customers from financial incentives”

“AFA Today an analysis of New Zealand’s investment adviser market” by David Chaplin

“Baseline review of Financial Advisers in New Zealand” MBIE

Submissions to the MBIE FA Act review from a number of parties

MBIE Issues Paper 2015 – Review of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008

FMA Strategic Risk Outlook 2015

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D Data request to insurers

- 1 *In the last 12 months what proportion of your business was adviser based? Adviser if possible to be categorised as one of AFA, RFA, QFE adviser and as independent or associated to the insurer.*
- 2 *In regard to the section 25 request from the FMA, in respect to question 1 (f), what proportion of business that commenced during the period was replacement business? Can that answer be split by the 6 categories for advisers in Q1?*
- 3 *Did you offer "takeover terms" for business in the period from 1 April 2011? If so what were the terms offered and the volume of business received?*
- 4 *An outline of commission terms you have offered over the last 12 months. This includes commission in the broadest sense including volume bonus overrides including trips, office support, marketing assistance, shares etc offered directly to advisers or via dealer groups. A split between the base individual policy commission and volume based overrides is requested.*
- 5 *Based on the information in Q4, what does that translate to as an initial commission level as a percentage of premium for the 12 months? What was the maximum and the minimum paid in respect a policy?*
- 6 *Based on the information in Q4, what will be the average renewal commission level based on sales over the last 12 months in policy years 2 and 3?*
- 7 *What are your current commission claw back rules?*
- 8 *Lapse rates. Can you please provide lapse rates in whatever way you analyse them, presumably by duration and product type/line and possibly sales channel? Can you provide the lapse rates for the last 4 years?*
- 9 *The average premium size for new business in the last 12 months split if possible by one of AFA, RFA, and QFE adviser and as independent or associated to the insurer.*
- 11 *The average age by gender of a new customer in the last 12 months.*
- 12 *Your MoS profit margin for new business written in the last 12 months split if possible by one of AFA, RFA, QFE adviser and as independent or associated to the insurer.*

E Overseas Developments in Life Insurance Advice

The pressure for change in how advice is delivered in the life insurance industry in New Zealand is repeated in many developed markets overseas. In all jurisdictions the concerns are focused around the high initial commission levels paid to advisers and in some countries there have been strong calls to ban all forms of commission.

We initially focus exclusively on developments in Australia and look at the developments in some detail as while there are some important structural differences in the NZ and Australian markets there are many similar problems in both.

E.1 Australia

Australia has witnessed a series of major reviews of the financial sector in the last 3 years prompted in many ways with the growth of the level of funds ordinary Australians hold in their superannuation funds. To illustrate the total FUM as June 2015 was A\$ 2.02 trillion and the balance for the average contributor amounted to \$100,000. On top of this the average contribution made to a scheme on behalf of a member was \$5,000 per annum.

Below we have summarised the contents of the key reports focusing on the points raised in them in regard to the Australian life insurance industry.

E.2 ASIC report

In October 2014 the Australian Securities & Investments Commission (ASIC) published a report "Review of retail life insurance advice" which was highly critical of the quality of advice and misaligned financial incentives within the life insurance industry. The report, based on a review of 202 advice files, found amongst other things:

- 37% of consumers received advice which failed to meet the relevant legal standard;
- Where an adviser was paid up front commission 45% failed but where another remuneration basis applied the failure rate dropped to 7%;
- Upfront commission accounted for 82% of the remuneration in the industry; and
- 96% of the cases which failed the advice test were sourced from up front commission policies.

The review further talked of the issue of the high lapse rate of policies ("churn") and how this went hand in hand with high upfront commission. The findings were considered to be a damning condemnation of the life insurance industry.

The report recommended that:

The insurers:

- Address misaligned incentives in their distribution channels
- Address lapse rates on an industry-wide and insurer by insurer basis
- Review their remuneration arrangements to support good-quality outcomes and better manage conflicts of interest.

The adviser groups to which the advisers belong:

- Ensure remuneration structures support good quality advice that prioritises the needs of the client
- Review business models
- Review the training and competency of advisers giving life insurance advice
- Increase the monitoring and supervision of advisers.

E.3 Murray report

The “Murray Report” was published in December 2014. This included recommendation 24: *“Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.”* It went on to recommend level commission but left the percentage amount to the market and industry.

An excerpt from the government response to the report in relation to that recommendation is attached as a further Appendix.

It is noted that on the 6th November 2015 the government formally announced its final response to the proposed reforms of the life insurance industry. The major points were:

- Upfront commission reduced to 60% of premiums
- Maximum renewal commission of 20% of premiums
- Changes to take effect from 1 July 2016 with a 3 year transition period
- An ASIC review to take place in 2018 to assess impact of changes. If they are judged to have failed to achieve an elimination of the conflict of interest issue then the government will legislate for a level commission regime.

E.4 Trowbridge report

Following the ASIC report the Australian Industry felt it had to respond, especially given other media attention on financial services sales practices. The Association of Financial Advisers (AFA) and the Financial Services Council (FSC), the industry body which includes the life insurance companies, jointly set up the Life Insurance Advice Working Group (LIAWG) with John Trowbridge as the independent chair, to respond to the issues raised in the ASIC report and “to ensure that Australians are adequately insured and receive world class financial advice.” The LIAWG was to:

- Provide a unified response to the issues;
- Address the 3 key issues of:
 - Remuneration structures;
 - Product design issues, and
 - Quality of advice.

Recommendations

To achieve the overarching goal, “to improve the alignment of interests across the life insurance value chain”, the Trowbridge Report makes recommendations on the following:

- Adviser remuneration;
- Adviser licensee remuneration;
- Quality of advice; and
- Insurer practices including a Life Insurance Code of Practice.

The report states the recommendations are looking to achieve a better alignment of interests between the different parties, including removal of conflicts over remuneration and advice. There are 6 policy recommendations, 4 implementation recommendations and 1 review recommendation.

The report refers to the recommendations as a package with each component important if the overall objectives of the reform are to be achieved.

A full list of the recommendations is included in Appendix E.

What were the particular issues driving these recommendations?

Conflict of interest

The remuneration terms are such that an adviser is incentivised to switch a customer from their existing policy to a new one after the period over which the commission can be clawed back has passed. Provided the customer is in the same health and the terms of the new policy are at least as good as the current one, in the short term, all parties win except the insurer. However if the terms of the new policy are not better and in particular if there are recent health issues the customer has likely been badly mis-sold.

Increasing value to the customer

Eliminating the conflicts noted above will improve the terms the insurer is able to offer on their products. Changing the product structure such as allowing for automatic improvements in an existing product will reduce the incentive to sell a new policy. In a similar vein introducing benefits which depend on the duration of a policy will likewise reduce the attractions of customers being sold new higher cost products.

Improve advice standards

The level of advice provided in a high number of cases reviewed by ASIC fell below the ideal standard. Improvements are therefore required in the upgrading of education and training and professional requirements of advisers.

This is in addition to the whole question of the need to raise the awareness of the customer of the value of proper advice and at the same time set in place processes which will allow the customer to make a positive choice on whether they wish to receive advice or are they just happy to be sold a policy.

E.5 UK

The UK introduced a ban on commissions on any product with an investment component from 1 January 2013. But commissions are still payable on protection only policies. To date the argument that banning commissions will result in a major fall in life insurance sales has been accepted.

E.6 Netherlands

The Netherlands decided in early 2013 that customers were best served by banning commission completely on the sale of life insurance products. This was in addition to introducing a ban on commissions on investment products.

The Netherlands started to look at this issue in 2002 when it set up their equivalent of the NZ FMA known as the AFM. Its ethos was that the financial services industry needed to start treating customers fairly. Over the next 9 years it gradually introduced measures to wind back the upfront initial commissions and started talking of a dollar cap on the commissions paid for insurance. It then extended its rules to ban any kind of sales inducements. In 2011 it announced that commission on all life policies would be banned.

The changes from 2006 were driven by a product mis-selling scandal.

In 2009 the AFM introduced a complete ban on inducements "soft dollars". One effect of this was to draw a clear line between the roles of the advisers and the manufacturers which was seen as a positive change embraced by both advisers and customers.

The Dutch market does have its particular features not the least that most life policies are sold in conjunction with a house mortgage as a person cannot take out a mortgage unless they have a life insurance policy in place.

E.7 South Africa

While in South Africa initial commissions continue to play a role in the market there are examples of alternative remuneration approaching driving successful outcomes. The example widely quoted is Liberty Life who in 2009 changed the basis of how they managed their commission based advisers. Essentially they worked hard to reward the good advisers by providing better benefits to their clients and terminated the advisers who had poor persistency records.

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F Recommendations in the Trowbridge report

<p>Policy Recommendation 1: That the Reform Model for adviser remuneration, being a system of level commissions supplemented by a client-based Initial Advice Payment available at a client's first policy inception and then no more often than once every five years, be adopted by the life insurance industry with progressive application through a transition period.</p>	<p>Implementation Recommendation 1: That ASIC be asked to endorse Policy Recommendations 1, 2 and 3 relating to adviser remuneration and licensee remuneration and, on the basis of that endorsement, to impose a suitable set of licensing conditions on life insurers that would give effect to these three recommendations.</p>
<p>Policy Recommendation 2: That there be a three year transition period where the five year rule is applied on a best endeavours basis immediately and, from a suitable date in 2016 for a period of 2 years, the industry operates according to the current hybrid commission arrangements with a cap on initial commissions.</p>	
<p>Policy Recommendation 3: That licensees be prohibited from receiving benefits from insurers that might influence recommended product choices or the advice given by the licensees' advisers</p>	
<p>Policy Recommendation 4: Ensure competitive access and choice for all advisers and their clients to available life insurance products by means of every licensee including on its Approved Product List (APL) at least half of the authorised retail life insurance providers.</p>	<p>Implementation Recommendation 2: That the recommendation that all licensees include at least half of the authorised retail life insurance providers on their APL be implemented by all individual licensees as soon as practicable and that ASIC review APL practices in order to provide suitable guidance to licensees in this area.</p>
<p>Policy Recommendation 5: That all licensees, in conjunction with their advisers, re-examine their culture, behaviours and practices regarding the advice process with the aim of raising consumer understanding of life insurance, ensuring informed consent from clients and reducing the administrative burden on advisers.</p>	<p>Implementation Recommendation 3: That a task force representing professional associations, licensees and advisers be established to explore and make recommendations to the advice sector, in conjunction with ASIC, for improving the advice process and associated documentation.</p>
<p>Policy Recommendation 6: That a Life Insurance Code of Practice be developed that is modelled on the General Insurance Code of Practice and aimed at setting standards of best practice for life insurers, licensees and advisers for the delivery of effective life insurance outcomes for consumers.</p>	<p>Implementation Recommendation 4: That a Life Insurance Code of Practice as at Policy Recommendation 6 be developed by the life insurance providers in a consultative process that embraces licensees, advisers and consumers.</p>
<p>Review Recommendation 1: That changes made in the life insurance industry as a result of the recommendations in this report be reviewed in 2020 to assess their effectiveness and, if then appropriate, to make further changes for the benefit of the industry and consumers.</p>	

G Australian Government response to FSI Report

Below is the Australian Government response to the Financial System Inquiry report in respect of recommendation 24.

Consumer outcomes	
Recommendation	Government action
<p>Inquiry Recommendation 24 — Align the interests of financial firms and consumers</p> <p>Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.</p>	<p>The Government agrees more can be done to better align the interests of financial firms and consumers. However, we intend to take a different approach to that recommended by the Inquiry for retail life insurance.</p> <p>We support the retail life insurance industry’s proposed reforms as announced by the then Assistant Treasurer on 25 June 2015. The Government will consider the extent to which legislation and/or action by ASIC may be necessary to implement the industry agreement.</p> <p>A Government review in 2018 will consider whether the new industry arrangements for life insurance advice have better aligned the interests of firms and consumers. If the review suggests further reform, consideration would be given to the Inquiry’s recommendation for a level commission structure or further extending the existing Future of Financial Advice provisions on conflicted remuneration to life insurance advice.</p> <p>The Government endorses ASIC reviewing the effect of current remuneration structures in stockbroking on the quality of consumer outcomes. The Government will also ask ASIC to examine remuneration structures in the mortgage broking sector.</p> <p>The Government will also develop legislation to allow ASIC to ban individuals from management within financial firms from operating in the industry.</p>