Quality of Advice Review –
Response to question on notice

Topic: Life insurance advice for super fund members and the middle market

Section **Page**

Appendices

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1. Introduction and conclusions

Under-insurance in the community

We have witnessed in recent times a substantial decline in life insurance new business and also in the number of financial advisers providing life insurance services. The declining new business is most pronounced in the *middle market*[1] and includes much of the same market that has a base level or default level of life insurance supplied by super funds through their group life policies.

There is also evidence that default cover in super funds is less than the personal and family insurance needs of many of their members, with the gap widening because of the declining numbers of advisers. In this context 'less' is not just amount of cover (sum insured etc) but also scope of protection (policy terms and conditions).

We therefore find that the *middle market* is under-serviced for financial advice and under-insured (among both those who have no insurance and those whose cover is inadequate relative to needs). This is despite Australia being a community where most members of the workforce are members of a super fund in which they have default life insurance cover.

Alongside this under-insurance phenomenon is the perception among many super fund members that to seek and obtain advice from an independent adviser and then purchase a retail or individual life policy outside the super fund would be a time consuming or costly process.

Responding to the under-insurance problem

in the context of super funds offering insurance cover but doing so without advice, it is understood that the Advice Review team recognises the need for external independent advice to be paid for, the difficulty of advisers trying to charge fees for service in life insurance and the fact that life insurers are in a position to spread advice costs across the life of a policy via commissions. There are also substantial complexities and associated high levels of cost in delivering independent advice that are recognised in the Proposals for Reform.

There is therefore a conundrum about how insurance advice might be arranged and funded in the *middle market* when a base level of cover is offered through group life, noting that an adviser's support can be valuable in arranging individualised additional or alternative cover yet neither the adviser nor the client is in a good position to fund the initial advice costs.

There is a strong awareness of this conundrum within the adviser community

The issue we are exploring is how to assist those super fund members who have group life cover from their fund and others without life insurance who have or might have an interest in obtaining independent advice about their insurances.

Evidence supplied by a range of life insurance advisers is that the majority of individuals who seek advice discover that their super fund's default cover is less than half of what they need and in many cases less than 20% of what they need. This situation is amplified in circumstances where the member has dependants. Many fund members seem to accept or assume, however, that their default cover is adequate for their needs but anecdotal information from advisers indicates that rarely is this the case.

This situation need not be seen as a failing of the super funds, for they have done an excellent job over the years in providing a base level of cover for their members and generating an increased understanding among their membership of the nature, value and importance of insurance.

[1] The middle market can be regarded broadly as comprising the under 40s or under 45s in the low to middle income to upper middle income echelons of the workforce. See also page 5, last paragraph

Main conclusions

The main conclusions in this paper are –

1. There are numerous impediments today to reversing the decline in *middle market* participation in needs based advised life insurance.
   - The decline is the primary market consequence of high adviser costs and capped commission rates that have seen business volumes falling significantly, by about half across the last four or five years, and the simultaneous and corresponding reduction in numbers of life insurance risk advisers
   - The depletion in business volumes has been greatest in the *middle market* and that is the primary subject of this paper.

2. The Proposals for Reform have the potential to overcome some of these impediments.

3. The proposed liberation of insurance advice services for both super funds and independent advisers would be most welcome but needs to be accompanied by adequate demarcation and safeguards regarding simple advice through the trustee vis-à-vis comprehensive advice through independent advisers.

4. improved cooperation in future between super funds and independent advisers has the potential for fund members to improve their access to needs based insurance protections, whether through simple advice from the trustee or independent advice or both.

5. The economics of independent advice are bound to be improved by the Proposals for Reform but at the lower and middle markets the maximum commission of 60% of premium is likely to remain inadequate. On this basis, my conclusion is that the best way forward is for the current commission arrangements to remain in place but for one variation: there be a premium threshold determined, below which the maximum commission payment is at the same level as if the premium were at the threshold
   - see also the chart on page 15
   - for example, if the threshold premium were $4,000, yielding a maximum commission at 60% of $2,400, all premiums below $4,000 would be eligible for a commission up to $2,400 (and insurers would be likely to offer lower commissions for the smaller premiums).

6. The remuneration arrangements for licensees should be reviewed and considered against the assessment made in my 2015 paper (see reference on page 16).

Independence and acknowledgments

This paper has been commissioned by a consortium of licensees whose goal is to see a workable set of modifications to the regulatory settings that would see a reversal of the decline in recent years in life insurance coverage within the *middle market*.

The consortium members recognise that a consensus of views on regulatory reform across the industry, whether licensees, insurers, advisers or super fund trustees, is difficult to achieve. For that reason they have asked me to prepare this paper as an independent adviser.

The findings and conclusions that I have arrived at in this paper relate to the questions understood to be of interest to the Review and therefore also of interest to the consortium. They are, however, my own independent views and may not coincide with the views of any one or more of the licensees.

Reliances and limitations

In preparing this paper, I have been given assistance through discussions and written material from a group of experienced life risk advisers and several licensee executives. This assistance has been invaluable. I have relied on much of the information and my own assessment of that information. I make no representation, however, as to the accuracy or completeness of the information.

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2. Summary of main findings

(a) The middle market is under-serviced and under-insured

(b) Impediments to rebuilding and re-energising the middle market: factors include –
- a common assumption that default super meets members' needs
- diminishing numbers of advisers
    - major causes are adverse economics and an unfriendly advice regime
- reduced access points for advisers (with banks withdrawing from advice a factor)
- complexities of the advice regime
- complexities of the underwriting and placement process

(c) Insurance offerings from superannuation funds have limitations -
- product offerings limited (single group life insurer, trustee is in essence an agent of the insurer)
- awareness of limitations of cover is low
- absence of claims advocacy
- premiums today are generally higher than in the individual market
- Potential liberalisation for super funds needs to distinguish adequately between product advice and comprehensive advice

(d) Service offerings from independent advisers comprise-
- initial advice (education, needs and objectives, presenting options)
- assisting client decision-making
- placement (including underwriting), claims support, continuing advice

(e) Sources of advice from independent advisers:
- referrals are mainly from accountants, lawyers and financial advisers who elect to outsource risk advice to specialists –
    - wider market access limited, especially since withdrawal of banks from wealth management
- under Proposals for Reform, greater potential for referrals from super funds, investment advisers, banks and others – more advice more often for more individuals

(f) Affordability and economics:
- LIF has been a problem because the advice regime is expensive, bureaucratic and unfriendly to customers, leading to poor economics for advisers -
    - the advice community believes that 60% commission is inadequate generally and leaves the *middle market* unattractive, with no incentive to invest in business expansion (recruitment, training, business promotion)
- simplification via Proposals for Reform should improve economics and customer attractiveness in the upper middle and upper market but *middle market* may still need an uplift in adviser remuneration
    - best approach would be to allow premiums below a threshold, say $4,000, to attract commission above 60% and up to the threshold commission (e.g. below $4,000 can receive up to $2,400)
- attention should be paid to the regulation and remuneration of licensees as an important component of the life insurance supply chain

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3. Impediments to dealing with under-insurance

What are the conditions that have led to the current contraction in life insurance business volumes, adviser numbers, demand for advice and demand for protection in the private market?

What are the impediments to resuscitating the market and increasing penetration into the under-insured and under-serviced *middle market*?

The under-insurance appears to arise for a combination of reasons, some of which reinforce each other and tend to perpetuate or even aggravate the position -

- a widespread assumption among fund members that default cover will meet needs
- promotion by super funds of their insurance offerings but advice not being available
- lack of awareness or understanding by many members as to how to evaluate their own needs
- diminishing numbers of advisers
- for advisers, a reduced number of access points following withdrawal of banks from the financial advisory business
- for fund members, lack of ready access to advisers
- complexities of the advice and compliance regime for both advisers and insurers
- insurer premium increases, noticeably for income protection
- complexities and contortions of the underwriting process that advisers have to navigate.

The lack of ready access for members and non-members to a life insurance adviser occurs because in many cases there tends to be -

- Limited awareness by individuals of their potential life insurance needs - see also the appendix which is part of a submission sent to me from one licensee: it is informative and echoes thoughts and experiences from many experienced advisers
- Limited interest and a degree of apathy towards examining their needs or seeking advice
- Lack of confidence to approach an adviser – most people do not know an adviser and, because it is a trust business, are wary of making a 'cold call' to someone, whether an individual or a firm
- Fewer independent advisers willing to support this *middle market* due to cost-to-serve exceeding income generated from these services.

We have a compliance regime and a remuneration structure for advisers that together have led to poor economics for advice businesses, especially in the *middle market*. Also the departure of the major banks from the advice business has contributed to and indeed accelerated the declining adviser numbers, influenced in part by the reduced volume of referrals for advice from customers of these institutions.

It might be imagined that the free or low-cost insurance advice available to most super fund members is a major problem for independent advisers seeking to earn sufficient commission income from their services in advising, recommending and placing supplementary or substitute cover to members who already have worthwhile cover in their super fund. That is not the key issue, however, as there are several other factors at play that also affect the demand for life adviser services.

Further on the middle market and the supply of advisers

The advice market has a wide spectrum of client needs from the simplest to the more complex -

- The lower market – which has never been advised
- The *middle market* – largely supported in the past by less experienced or less qualified advisers (the banks operated in this space)
- The upper market – where client needs, desire to seek advice and more highly experienced or specialty advisers are well matched.

In more recent years the *middle market* has seen the banks withdrawing from this market, the LIF reforms adversely affecting the economics. We have also seen the enhancement of education and professional standards of advisers. As a consequence, the *middle market* has lost the majority of advice support it once had. Historically, all segments of the market have been under-advised for some time but recent changes have particularly exacerbated the shortfall in the *middle market*, leading to the more experienced adviser being less willing to support this segment of the market.

Summary

In summary, we have an inadequate supply of advisory services and at the same time a lack of demand for services. Together they operate in an adverse cycle of continuing and perhaps increasing under-insurance. A fundamental problem is the poor economics of advice businesses caused by high advice costs, driven largely by a demanding and inefficient compliance regime alongside a remuneration structure for advisers that disincentivises them to support and grow a *middle market* portfolio.

If the Proposals for Reform are introduced, some of these impediments are likely to be mitigated or even overcome but, without some remuneration reform, it is hard to see the *middle market* re-energised.

There are 5 main factors to consider –

- the heavy compliance regime imposed on advisers and insurers that has led to marginal or unprofitable advice businesses that are unattractive from a career perspective, causing the departure of many advisers and the inability of remaining advisers to recruit, train and develop new advisory staff
- the wide acceptance or assumption by many super fund members that group life insurance cover is meeting their needs (notwithstanding evidence that for a great many members the cover does not meet their needs very well) – see also the Appendix on p17
- a general lack of interest by super funds in assisting or encouraging their members to seek independent advice for their insurance needs and, at some funds, barriers to members engaging effectively with independent advisers
- a remuneration structure for advisers that disincentivises them to support and grow a *middle market* portfolio
- limited access to independent advisers for consumers in the *middle market*, whether super fund members or not.

4. Understanding the insurance in super and insurance adviser markets

Super fund insurance offerings

There are multiple aspects of the insurance offerings of super funds that lead to the suggestion that many of their members would stand to benefit from personalised advice, for example –

- although super fund insurance documentation is generally of a high standard, it is typically around 40 pages and it is difficult for most members to navigate their way through it without the assistance of an adviser
  - i.e. disclosure is good but the ability of most members to absorb and understand the material and then to act effectively on it is very limited

- policy conditions for the insurances on offer from super funds are often more restrictive than for retail policies and generally members need advice in order to become aware of and become able to take a knowledgeable view on the differences

- contract terms can be altered at the trustee's discretion whereas the terms of retail policies are set at inception and fixed thereafter -
  - a recent example is the changes gazetted by Vic Super who announced they will cease their current contract with MetLife: the result is that the *own occupation* definition for income protection under professional occupations ceasing (a major limitation)
  - members are always exposed to this risk when their cover is held inside a super fund: guaranteed renewability, which is available through retail insurance, means the insurer cannot remove unilaterally contracted features, definitions and benefits.

- super funds are not able to offer choice of insurer: the super fund will have a contractual arrangement with a single insurer but independent advisers are able to seek out the most suitable policy for the member from across the whole market
  - the significance of this point can be found firstly in identifying any cover restrictions for the super fund's insurances, arising in part from a lower risk appetite in the underwriting process, and secondly during the underwriting process because different insurers have different risk criteria
  - it is also notable that the insurer's group life policy with a super fund does not make available to members any other policy offerings of the insurer
  - the adviser, as agent[2] for the member, not only can consider the whole market but is professionally obliged to do so in an effort to meet the member's needs on a 'best interests' basis; by contrast, the super fund, acting as agent for the insurer, is effectively making a 'take it or leave it' offer to the member

- trauma cover is not available within super funds and many advised clients value this cover which will support medical and other costs if and when a trauma claim arises

- retail premiums in many cases are lower today than corresponding super fund premiums (which in the past was mostly not the case but the market has changed); as a result retail clients often receive better quality coverage and at a lower price, with better advice and client education; with the advice effectively funded by the insurer

[2] The adviser may also be an agent of the insurer at law because of the contractual nature of the policy and the receipt of commission but, for all practical purposes, the adviser is agent of the client and, consistent with the adviser's best interest duty, advocates on the client's behalf in seeking the best, the fastest and the fairest outcome for the client

- *this is an extraordinary development of some magnitude* but also needs to be looked upon from an underwriting viewpoint – see also table and notes below

- super funds usually pay premiums monthly for their members and that attracts a loading of 7% to 9% against annually paid premiums; an adviser will usually be able to assist the member to pay annually, using the member's fund balance, but the super funds generally do not or cannot readily do this

- premiums within the super fund are tax-deductible against the 15% contributions tax (except for trauma) so default cover and additional cover can both take advantage of this situation –
  - some funds make this adjustment for their members for default cover although members may not know if it has been done
  - advisers can ensure that this tax position is understood and utilised for the benefit of the member in taking additional or alternative cover
- when a member makes a claim on the super fund insurer, the member lodges it with the trustee who is acting as agent for the insurer; by contrast, an independent adviser is the agent of the member with a duty to the member to ensure the best claim outcome and will always advocate for the member
  - when a claim is made by a fund member on the fund's insurer, the claim is being lodged with the trustee and will be facilitated by staff of the trustee: consistent with their position as agent for the insurer and also often with limited claims expertise, they will delegate to the insurer the handling of the claim and usually follow the insurer's position

  whereas
  - if an adviser is involved, the adviser as agent for the member will be able to represent the member to the trustee and then directly to the insurer or, if the insurance is with a different insurer, the adviser will lodge the claim directly with the insurer; in both cases, the adviser can and will advocate for the member
  - this advocacy is often critical in life insurance claims because of the traumatic effect that the claim event may have on the member and family; claimants need the utmost assistance at claim time including the concomitant challenge as advocate for the claimant in dealing expertly with the insurer.

Premium comparisons - like with like, super fund group life vs indiviual life

Client	Life SI $000	TPD SI $000	IP pm $	Premium SF	Premium LI	Premium saving LI
A	2,133	1,002	9,033	7,112	3,283	54%
B	2,000	2,000	-	1,406	912	35%
C	2,000	2,000	-	1,804	1,130	37%
D	1,000	1,000	-	5,404	2,992	45%
E	1,000	1,000	-	5,096	1,377	73%
F *	2,000	2,000	-	2,517	1,691	33%
G *	2,000	2,000	-	2,292	1,749	24%
H	875	835	4,700	4,908	3,306	33%
Simple average of premium savings excluding E as an outlier						37%

Premiums are stepped (i.e. increase with age)

* TPD cover is: SF is any occupation

LI is super linked own occupation (= wide cover)

This table offers comparisons that will be surprising to many observers. –

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- ***In times past, group life cover in super funds was very well priced and generally lower than individual life and by some margin. Today the position is reversed.***
- The comparisons shown are understood to be representative, not selective. They are quotes which are recent live examples sourced from several different super funds and several different insurers.
- The individual life premiums include commissions funded by the insurer (the normal 60%/20%)
- The group life policies of super funds are understood to include trustees' administration costs.
- The primary reasons for the reversals in relative premiums appear to be that many super funds have been having poor claims experience such that the group life insurers have increased their prices in recent years while individual life pricing is based on individual underwriting.
  Expressed another way, each of the individuals in these examples is a healthy life whereas the super fund quotations will reflect a degree of averaging or pooling across healthy lives and less healthy lives, also influenced by standard loadings for various declared occupations or types of work; in practice the super fund rate tables do rough justice from an underwriting viewpoint compared with individually underwritten policies.

The services of independent advisers

The services offered by advisers include –

- Initial advice: generally the process of educating the client, clarifying needs and objectives, then presenting options, culminating in a decision by the client as to what he or she will do -
  - once a potential client has been able to engage with an independent adviser, the needs and objectives of the client can be ascertained; when understood and agreed by the potential client, the options generally become clear to the member and, with the aid of the adviser, can put the member in a decision-making position.
- Placement: once a client agrees or decides to take out an insurance policy, the adviser follows up on medical conditions, tests and reports, then goes into broker mode to assess the market including all underwriting matters and respond with recommendations on what insurances to purchase
- Claims: support including representing the client when a claim is to be lodged and also advocating for the client throughout the claim process
- Continuing advice: reviewing the client's needs from time to time, perhaps annually on renewal, and also on any 'life events' such as marriage, mortgage, children, change of employment circumstances.

By contrast, none of these services are usually supplied by trustees who normally pass applications to the insurer and communicate underwriting requests and decisions within the standard terms agreed for the fund's group life policy.

5. Reaching the independent advice market

Where do advised clients come from?

The first step towards a person becoming a potential new life insurance client seeking advice is that there be some stimulus for the person to seek advice, for example a recommendation or referral from an accountant, investment adviser, lawyer, trusted friend or family member. For newcomers, there is rarely a spontaneous effort to find someone to offer advice. This environment lends itself to advisers supporting the upper market including clients with complex needs.

When such referrals are acted upon, advisers find that 80% to 90% of the referrals purchase some form of cover. This experience suggests that the coverage obtained by most members from their super fund is inadequate for their needs once these needs are properly identified. It arises through the advisers identifying client needs and assisting the clients to meet those needs. The advisers see their initial role as being in three parts: educate, identify needs and objectives, propose options.

As noted in the previous section, risk advisers as a whole have fewer access points today for new clientele following withdrawal of banks from the financial advisory business.

The challenge for advisers from a business viewpoint is to rebuild access points. The problem for the community and its workforce in response to an under-served and under-insured *middle market* is the impediments noted in the previous section – see also next section.

Access for super fund members to independent advisers

Super funds have not been a major source to date of referrals to independent advisers. The points below are contributors to this situation but there are other impediments as already noted. The Proposals for Reform, however, contain some elements which, if introduced and embraced by super funds and advisers, could contribute to some growth in the advice and insurer markets.

- *Account information*

  If a member wishes to use an adviser, the adviser will need to have full and prompt access to the member's insurance details. Some funds are very helpful, others less so.

- *Attitudes towards external or independent advisers*

  Some funds readily accept any member interest in using an external adviser but some funds do not.

  In the context of the Proposals for Reform, there is potential not just for a more open approach by super funds but also for active cooperation between trustee management and financial adviser groups.

- *Alternative insurance cover*

  Fund members are able to purchase insurance cover outside their super funds. When an adviser is involved, the adviser will often advocate cancelling the fund cover rather than retain two policies for a single risk. The outcome is driven essentially by best interest requirements. To have cover with a single insurer simplifies matters for both the member and the adviser regarding consistency of cover, underwriting and claims. Some funds facilitate such cancellations, others do not.

In summary, advisers can encounter barriers from super funds in their efforts to provide meaningful advice to their clients but the other impediments in the current system described in section 3 play a major part. A more cooperative approach in future across the super fund industry operating with improved economics could contribute usefully to ameliorating community levels of under-insurance. The Proposals for Reform, if introduced, would play a valuable part in this process.

6. Responding to the impediments?

Effects of an increased regulatory burden and the LIF reforms

Commission rates in the *middle market* are not the only factor that has led to reduced business volumes and numbers of advisers in recent times but it appears to be one of the two most significant ones. The other is the increased regulatory demands on advisers. These factors have led to poor economics for the advice business: increasing costs at the same time as reduced business volumes.

Commission arrangements changed from market rates at typically 110%/10% or 80%/20% to 80%/20% maximum rates from 1 January 2018 reducing to 60%/20% from 1 January 2020. The reduced limits were expected to be accompanied by regulatory initiatives that reduced adviser costs.

Although the LIF reforms and some other regulatory initiatives were intended to offer simplification of SoAs and other details, their implementation and other regulatory constraints had the opposite effect. The burden on advisers and the 'customer unfriendly' consequences for potential insurance buyers have been negative, to say the least.

The primary market consequences of higher adviser costs and the capped commission rates have been business volumes falling significantly, by about half across the last four or five years, and the simultaneous and corresponding reduction in numbers of life insurance risk advisers. Also, not surprisingly, the depletion in business volumes has been greatest at the lower end of the market, i.e. the *middle market* that is the primary subject of this paper.

Removing impediments?

The current situation could change, perhaps substantially over time, if the whole advice system in life insurance became simpler through –

- super fund members and others more readily obtaining access to advice
- advisers being able to offer more advice to more individuals more often
- super funds being supportive generally of members seeking external advice.

The Proposals for Reform if adopted will likely make a major positive contribution to such simplification because of the proposed stripping away of many of the administrative and compliance requirements currently in place.

The competitiveness of individual life premiums today compared with group life, as exemplified in Section 5, are favourable. At the same time the advice has to be affordable to clients and potential clients, including super fund members, if there is to be any stimulation of the demand for risk insurance advice. The pricing situation will deliver that so long as commissions continue to be available to advisers such that advice and distribution costs can be spread over time. A corresponding supply of advisers will of course be needed if demand does rise.

Stimulating the demand: if the regulatory environment is liberalised as suggested by the Proposals for Reform, it is possible we will see some entrepreneurial initiatives of a kind that are unlikely to occur otherwise, for all the well known reasons including several points above that tend to limit access to advisers and also limit the viability of advice businesses.

7. Remuneration considerations

There are three market participants to consider: advisers, licensees and insurers –

- *Advisers* are usually remunerated by the insurer with a commission of 60% initially and 20% on each renewal. These rates are maximum rates but they are also standard market practice.

- *Licensees* are remunerated through fees charged to their Authorised Representatives. Before the LIF reforms, they were able to receive various payments, some incentive based that created conflicts of interest. Licensees are not advocating their reintroduction but there are questions to be pursued regarding licensee viability and remuneration.

- *Insurers* of course do the pricing and commissions are struck as a percentage of insurers' underlying prices. Their economics on a per policy basis or variable cost basis may have improved with the LIF reforms (lower commission rates) but lower business volumes have interfered because of insurers' fixed costs.

How do the remuneration arrangements affect the availability and the financial viability of the adviser, the licensee and the insurer?

Advisers

The first question to ask about adviser remuneration is whether commissions are an appropriate way to remunerate advisers, against the alternative of fees, where -

- by commissions we mean payments by the insurer to the adviser on inception or renewal of a policy (usually calculated as a percentage of the premium but not necessarily so)

and

- by fee we mean a payment made by the client to the adviser at the time that advice is received or when the policy is issued (and specified either as a dollar amount or a percentage of the premium).

Commissions or fees?

As is widely understood, fees for insurance advice that are additional to an insurance premium are unpopular and militate against their use by consumers seeking advice and diminish interest in obtaining life cover through advisers. This fee issue is strongest in the *middle market* but also affects the higher end of the market.

Commissions on the other hand can be funded by insurers. Insurers have the capacity and willingness to do so and they are able to spread the costs over the life of the policy, which advisers and clients are usually either not able or not willing to do.

It is often suggested that insurer funding is an automatic conflict of interest that should not be permitted. It should be remembered, however, that in practice the adviser is an agent of the client not the insurer, with a fiduciary duty and a range of other obligations to the client. Also in a competitive premium environment where commissions are standard and advisers, in broker mode, are obliged to find the best cover commensurate with the client's needs, there is no arbitrage benefit for the adviser on commission revenue. For these reasons it seems appropriate to consider not the discontinuation of commissions but rather steps that are or that might be put in place to minimise any perceived or actual conflict of interest.

It is worth adding that any attempt to transition the whole market from insurer funded commissions to client funded fees would inevitably cause a further contraction in life insurance new business and renewals. Clearly that would be contrary to the goal of improving the availability and accessibility of life insurance to the *middle market* (and perhaps to the whole market).

The current commission conundrum (independently of insurance in super)

We note that some submissions to the Review have argued that the 60% maximum should be lifted to 80%, which was a common rate before the LIF reforms. Others have argued that, although overall 60% is inadequate for most advisers, the primary reason is the regulatory burdens on both the adviser and the insurer that are in place today. Therefore if major simplification emerges along the lines of Proposals for Reform, there will probably be no case for lifting the rate above 60%. For the *middle market*, however, where the advice business is essentially uneconomic today, it is not clear that the current 60%/20% arrangement would have a beneficial effect on the business. After all, there is a major access problem for both advisers and their potential client market.

From the KPMG advice to the FSC on adviser costs and from other analyses and information, the initial cost of insurance advice and placement is believed to be typically in the range $3,000 to $4,000. At 60% commission, that level is reached if the annual premium is say $5,000 to $6,000 or more. The result of this situation is that, while advisers will generally offer their services where annual premiums are below this level, it is clearly in their interests to advise clients or potential clients who will likely be paying higher premiums.

At present there are cross subsidies by advisers: they tend to mitigate their costs for lower levels of premiums and also for advice given but not remunerated (where the potential client does not proceed with insurance) against the larger commissions earned on higher premium policies.

Under the Proposals for Reform, there should be a worthwhile improvement in both the economics of the adviser business and the quality and attractiveness of the services that advisers would be able to offer. That is because of the major simplifications to the regulatory environment, the opportunity to give intermittent personal advice without regulatory complexity and, importantly, the freeing up of adviser time to invest in business development (more potential clients and more advice to more clients more often), staff recruitment and development and other matters.

Hence the situation will undoubtedly be improved if and when the Proposals for Reform come into force. While analysis is speculative at this stage, it is probably reasonable to assess future remuneration levels before inflation against –

(a) a lower typical advice cost of say $2,000 to $2,500 (compared with $3,000 to $4,000 today)

and

(b) an improved quality and scope of service to the client, both initially and throughout the term of the client's policy.

At 60% of premium and a typical cost of $2,000 to $2,500, the question then becomes: how suitable is a 60% initial commission, expecting to correspond in future to annual premiums of around $3,000 to $4,000? And how suitable is a 20% renewal commission?

The current regime tends to cater to the higher end of the market at the expense of the *middle market*. It also has the effect of exacerbating cross subsidies that are inherent in the commission system because adviser costs are not closely matched to their income.

Larger premiums will generally require more service and therefore cost more for the adviser than smaller premiums. Reliable analytical evidence is not readily available along the premium scale, i.e. for large annual premiums of say $10,000 to $20,000 or more. Many advisers believe, however, that the relationship between premium and the cost to serve is actually linear, i.e. the advice and servicing costs tend to rise roughly in proportion to premium, owing to additional complexity, additional needs, greater underwriting demands (noting that higher premiums are needed at higher ages) and other factors.

> At 60%, there is bound to be a better matching of revenue against cost to serve than at the pre LIF rates of 80% to 120% but there are many advisers who believe that the 60% needs to revert to 80%, largely because of the heavy regulatory burden.

It is probably reasonable to expect that, under the status quo where average adviser costs are believed to be in the range $3,000 to $4,000 –

- for annual premiums above about $6,000, for initial commissions of $3,600 and up, advisers can generally meet or exceed their costs but
- for annual premiums below about $4,000 and initial commissions of $2,400 or less, advisers will be unprofitable.

There is therefore a clear argument for exploring some modifications to the current maximum commission scales. Also it may be desirable to consider a pricing structure that is different from a single percentage rate of commission on premium in an effort to match adviser revenue more closely with costs across the premium spectrum.

An important goal of such modifications is to make the lower middle and *middle market* more viable for advisers to service. It should thereby contribute to an increase in demand by potential clients in that segment of the market and similarly an increase in supply of advisers generally and especially in that market.

Upper middle and upper market

At this stage, the Proposals for Reform are not in force and, if they come to pass, their full effect cannot yet be predicted. It would therefore seem inappropriate to suggest at this stage any material change to the 60%/20% formula for the upper middle and upper market, meaning for premium levels of say $6,000 a year and up.

Put another way, if we can all have confidence that costs will reduce, it would be hard to make a case for any rate higher than 60%. At the same time it would be speculative and also undesirable from a supply perspective to think that a lower rate than 60% ought to be contemplated.

Middle and lower middle market

A way needs to be found to increase adviser revenue at this end of the market, i.e. for annual premiums up to say $4,000 or $5,000.

Two possible techniques have been identified –

(1) Linear (at say 60%) with a minimum payment

Allow commissions that are the higher of 60% and a fixed dollar amount,
e.g. if the fixed amount were $2,400, premiums above $4,000 would attract 60% maximum and annual premiums below $4,000 could attract up to $2,400.

(2) A 'flattening' of the commission scale

Set all commissions as a fixed dollar amount supplemented by a percentage of premium,
e.g. an amount of $2,000 + 30% of premium would result in a minimum of $2,000 and more than 60% up to $3,300. Above $3,300 it would be less than 60%; at $10,000 it would be 50%.

All ideas such as these options become largely a matter of opinion or judgment as to what is most appropriate. Criteria to be applied might be –

- how much adviser financial support is appropriate at the low end of the scale?
  - *enough is needed to fund advice for clients with modest insurance needs but where advice is valuable*
  - *advisers should not have an incentive to chase small policies to build commission income*

- how high should commissions be for larger premiums?
  - *enough is needed to fund advice for clients with more complex insurance needs but where advisers should not have an incentive to chase larger policies to build commission income*

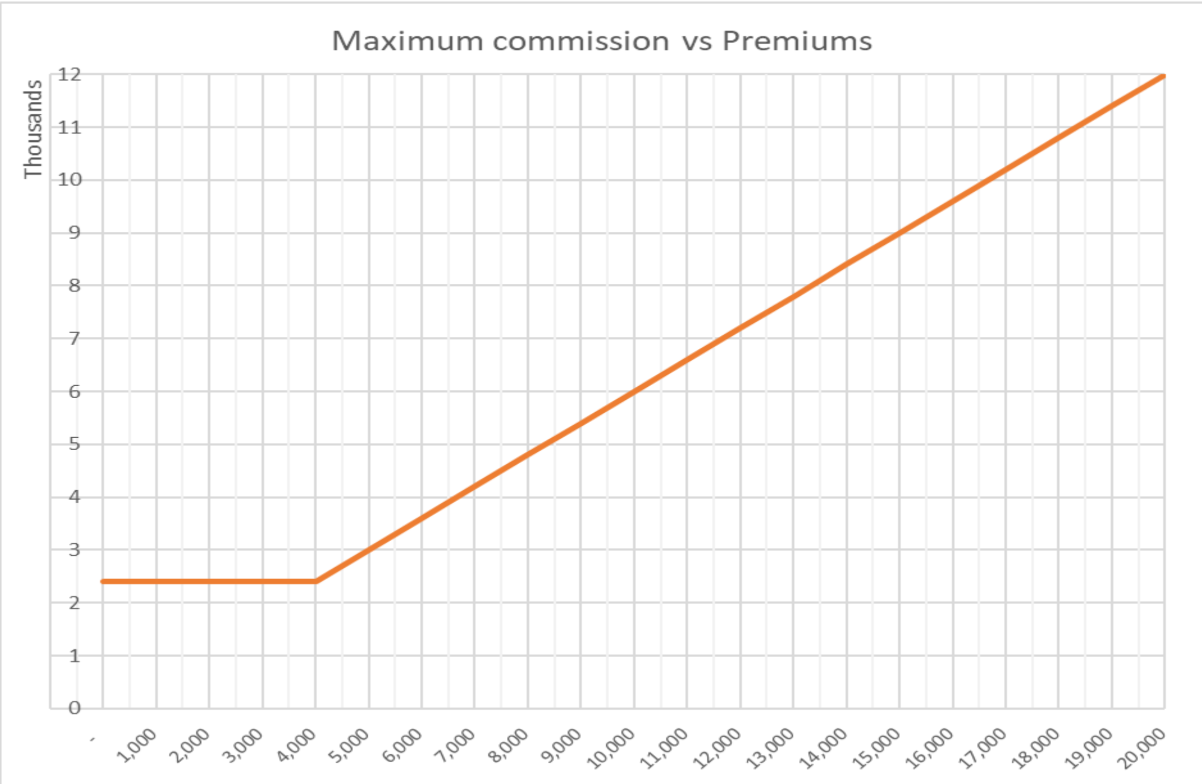
  - *it should also be remembered that the 60%/20% commissions are maxima: an adviser may choose to charge a lower rate than the maximum or a fee for service and nil commission*

- what level of commission is appropriate in the middle range, for premiums of say $4,000 to $8,000?
  - *the balance may well be where the bulk of clientele needs are met and the adviser is fairly remunerated by reference to typical advice costs.*

Of the two techniques above, the first is superior for several reasons –

- It is simpler to administer and to explain to clients and others
- iit would not disturb the upper middle and upper market and it is desirable not to do so at this time because the 60%/20% system has only been in operation for 2½ years and –
  - if the Proposals for Reform are introduced, there should be no case to call for an increase in the initial commission above 60%
  - the poor economics in the current regulatory environment should improve under the Proposals for Reform but at this stage there is no available data to assess the financial impact
  - considering the lower end of market, it is likely that, for small policies, the insurers would not wish to offer the full allowable amount because of its likely effect on their pricing, so the insurer market would probably act to limit any tendency by advisers to seek unduly high commissions at the low end of the market.
- Overall, it seems that the current level of 60% is barely adequate at present but the Proposals for Reform if introduced may change that and may well assist in re-energising the adviser market to the benefit of more consumers and more investment in the development of adviser businesses.

Proposal for maximum initial commissions for smaller policies



Notes: (a) The sloping line in the chart is 60% of premium
(b) The horizontal line is set here at $2,400 but could be a different amount
(c) The two lines meet at $4,000 premium and $2,400 commission
(d) Both lines are maxima: insurers are free to use lower commissions and would be expected to do so in some cases where the line is horizontal

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Conclusion

On the basis of the above, my conclusion is that the best way forward on adviser remuneration is for the current commission arrangements to remain in place but for one variation, which is that there be a premium threshold determined, below which the maximum commission payment can be at the same level as if the premium were at the threshold.

For example, as in the chart above, that threshold premium might be $4,000 per annum, yielding at 60% a commission of $2,400. A different threshold could of course be selected but the same principle would apply.

Adviser commissions and super fund insurances

Some concerns have been expressed about the idea that independent advisers may have limited interest in advising super fund members on the basis that the commissions that they would earn would be too low to justify the advice costs they would incur. I believe that that is not very likely and less so if the Proposals for Reform lead to more access by independent advisers to super fund members. Access would be further improved if the commission approach advocated above for smaller premiums is adopted.

Licensees

The licensee remuneration question deserves attention for the role that licensees play in maintaining compliance, delivering training and support services to individual advisers and supporting healthy and professional relationships between insurers and the adviser community.

Much was said on this topic in my 2015 report. I refer the reader to pages 8 and 40 to 44 of my 2015 report which can be found at this link: Trowbridge Report - Financial Services Council (fsc.org.au).

Insurers

Insurers will adapt their businesses including their pricing and underwriting arrangements to whatever reforms emerge from the Quality of Advice Review. They will of course welcome all reforms that encourage more interest in life insurance and greater access for consumers. It is also possible that, if greater demand emerges from the reforms, the insurance market may become more competitive. No further comment is offered at this stage.

APPENDIX A

"The essence of life insurance advice" - extract from a licensee submission

"For a client to make an informed decision, selling needs to be viewed as the pathway to becoming informed. Being informed is not to be understood through the lens of factual information, that would be to misunderstand the context of knowledge, the context of experience and the context of good decision making.

Selling is the process that helps clients understand not only the factual information, but the context within which that factual information is relevant to them and the trade-offs of that information in their situation and the range of intelligent and legitimate options on the table available to them.

That process requires time and cannot survive, on scale, within a "high risk" fee-based environment, it can only exist in a "low-risk" commission-based environment.

A fee-based environment, whether it's flat fee or hourly rate, incurs an explicit cost on the customer and that exposes the customer to an explicit risk for something that is of unknown value thus shutting down the pathway to becoming informed.

A commission-based model allows clients to engage with an adviser in the lowest risk way possible to allow the adviser the opportunity to reveal the needs that the client had not seen or understood before and in so doing decide to make a new decision based on new information."

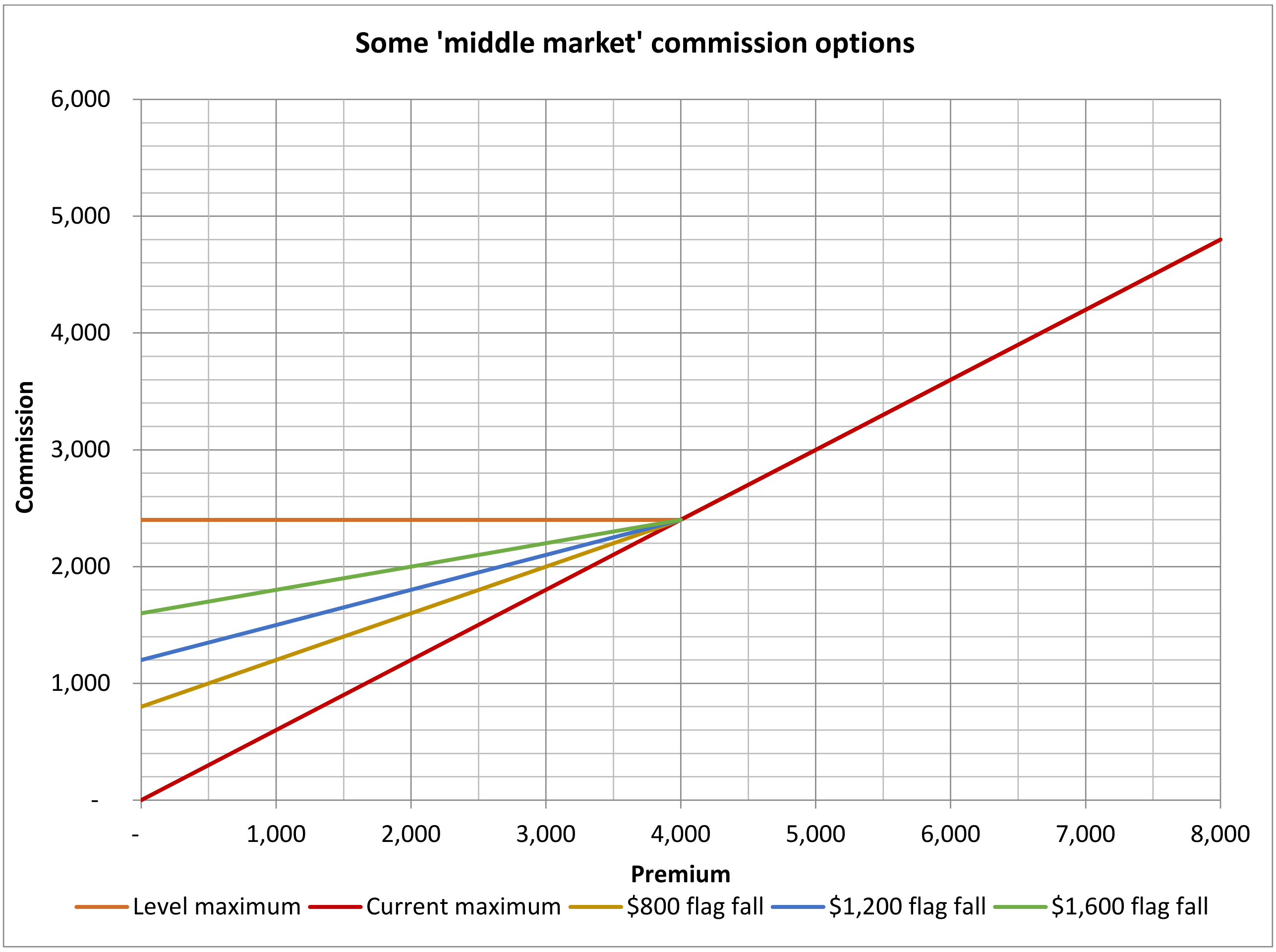
APPENDIX B

Commissions and the middle market – supplementary thoughts

Some commission options for the lower end of the market

At the QAR Roundtable on Friday 11 November, the question arose as to whether the 'level maximum' commission idea (page 15 of my paper) would work and, in particular, whether for smaller premiums, say less than $2,000, it might be exploited or become excessive relative to the premium. The need for simplicity was noted as a consideration.

Clearly there are many possible ways mathematically to structure the commissions. Simple examples are in the chart below, where the three sloping lines from zero to $4,000 premium represent a commission with a 'flag fall' or entry commission at nil premium rising linearly to $2,400 at a premium of $4,000. At $4,000 and above, the commission is a uniform 60% of premium.



There are also other practical questions. An obvious one is a client with two or more policies: a client might have two policies with $2,000 premium on each. Logically the two should be bundled together and treated as one before any 'concessional' commission can be received (and it might be remembered that in my 2015 paper I recommended a single 'initial advice payment' that was intended as a per client payment not a per policy payment – the aim was to recognise this very problem). The insurer also has an interest assuming the policies are with the same insurer.

As noted in the paper , the suggestion of a level maximum commission needed some emphasis on '*maximum*'. In other words, there is a three way 'deal' to be done in which client, adviser and insurer all have a part to play –

- The **client** expects a fair premium for the cover and the premium should contain commission which is a fair price for the adviser's services. There may be just a single policy or more than one policy.

- The **adviser** has an expectation of a fair advice payment for the services provided. That is not normally thought of as a per policy payment, for it too is based on the total services rendered to the client.

- Then it is the **insurer** funding the commission. Neither the insurer nor the client will be comfortable for the insurer to charge for an accumulation of 'concessional' commissions across two or more policies.

There is therefore a modest conundrum in dealing with this problem. It is both the multi policy question and the need to avoid creating an incentive for the adviser to go to two different insurers rather than one for the total cover.

It was these factors that led me to suggest in the paper that, in this lower premium area, there be a level maximum commission in conjunction with a market solution that would likely offer actual commissions below the maximum.

I will not attempt to identify and solve all the issues here. It is a situation that looks like it needs its own proper investigation if the conclusion of the Advice review is that some form of commission uplift beyond 60% of premium is desirable and appropriate for the middle and lower market.

I and many others believe that, to fulfil the goal of accessibility and availability, requires such an uplift. Design detail may not be essential at this stage.

The key requirement is therefore one of principle: if the goal is to succeed in supporting an advice market that enables advisers and insurers together to be able to serve the middle and lower market well in the future, advice payments funded by insurer commissions will need to be greater than 60% of the first year's premium for this end of the market.

APPENDIX C

Restating the case for a viable middle market

The middle market and the Terms of Reference

The theme of my paper is a reassessment of the under-servicing and under-insured middle market for life insurance. It encompassed a review of the main reasons for the recent decline and the potential for re-energising this middle market on the back of the regulatory simplifications that are contained in the Proposals for Reform. It concerns one of the express goals of the Review:

> "The Review will consider how the regulatory framework could better enable the provision of high quality, accessible and affordable financial advice for retail clients. "
>
> *… Paragraph 2 of the Terms of Reference*
>
> and the Review "will include examination of the legislative framework for financial advice" comprising, among other things, "The life insurance remuneration reforms, and the impact of the reforms on the levels of insurance coverage".
>
> *… Paragraph 3.1.5 of the Terms of Reference*

To achieve this goal will involve super funds, licensees, life risk advisers and insurers collectively building a stronger market capability, for the benefit of super fund members and others.

Implicit in my paper is an appeal for recognition in the regulatory framework of the different characteristics of life insurance and associated advice on the one hand and, on the other hand, funds management and investments, inside and outside super funds, and associated advice.

The market context is –

- **Potential clients**: for many individuals and families (super fund members or not) who have a mortgage and/or dependants or other commitments, there is a strong case for them to obtain life and income protection insurance and often more (TPD, trauma) beyond the offerings of super funds. These potential clients need to find an adviser and that relies in part on re-energising the adviser market with the capacity to recruit and develop new advisers.

  If an adviser is found, the client and adviser can often look forward to a long-term relationship if the client is satisfied with the adviser's services.

- **Advisers:** potential clients need an **adviser** who can understand and interpret their needs. To rebuild a viable adviser market requires economic remuneration for the services needed and that means overcoming the poor economics of today's adviser market.

- **Insurers**, being those who meet claims and also fund through commissions the advice costs, will rebuild a more vibrant and competitive market if the business volumes grow through greater client demand and fostering more attractive careers for new advisers leading to an increasing supply of advisers.

Rebuilding the adviser market: regulatory arrangements?

The Proposals for Reform and the Proposal in the Consultation Paper appear to leave open the credentials required of personnel offering advice without being relevant providers while also requiring the licensee to accept full responsibility for the quality of advice being offered.

Some elaboration and clarification of how such a regime might operate is important. In particular, is it expected that there will be regulatory conditions imposed under legislation or is it expected that a self-regulatory regime might operate? If the latter, which may be difficult across the various segments of the industry, to what extent might collaboration among groups of one or more insurers, licensees (including super funds) and advisers be feasible without breaching competition law?