Submission relating to authorisation application to the Australian Competition and Consumer Commission - A91556 & A91557

Summary

The Australian Securities and Investments Commission (ASIC) has recently reviewed the sale of add-on insurance by car dealers, in three separate reports: REP 470, REP 471 and REP 492.

'Add-on' insurance is a term used to describe an insurance product that is 'added on' to the sale of another product which is the main focus for the consumer. Our reviews focused on add-on insurance sold to consumers when they purchase a new or used car, which covers risks relating to the car itself (e.g. mechanical breakdown) or to a credit contract if the consumer takes out a loan to buy the car (e.g. insurance to cover loan repayments if the consumer becomes ill).

The add-on insurance products covered in our reviews are those which are commonly sold by car dealers: consumer credit insurance, loan termination insurance or 'walkaway' insurance, GAP insurance, tyre and rim insurance and mechanical breakdown insurance.

In principle, ASIC supports a cap on commissions to help address some of the concerns identified in our reviews with the sale of these products.

Our reviews found that consumers are paying too much for add-on insurance sold through the car dealer channel, in part due to very high commissions paid by insurers to car dealers to sell the add-on insurance.

The *Aioi Nissay Dowa Insurance Company Australia Pty Ltd & Ors - Authorisation application* ("the application") represents an industry response to the concerns raised by ASIC, as the application seeks to address the low value of these products.

ASIC is supportive of the industry's initiative, and the underlying recognition that there is a need for change. We also recognise that, given the complexities of this market and the long-standing poor consumer outcomes, it is important that any proposal to cap commissions will deliver measurable improvements to consumer outcomes.

This submission outlines the reasons for ASIC's support for a cap on commission while also responding to potential impacts raised by the application and in the submissions from stakeholders.

ASIC does not view the application as a complete solution to the many and varied concerns we have identified in our reviews of add-on products. Rather, the application addresses particular concerns regarding the sale of add-on products, namely the high premiums consumers pay and the conflicting incentives to car dealers to sell add-on products at these prices. The application resolves an identified 'first mover' issue which means that for a single insurer to reduce commissions unilaterally would mean that they would incur a significant commercial disadvantage (i.e. car dealers would likely choose not to sell their product, and would instead choose to sell an add-on product with a higher commission payment).

The application therefore complements continuing work by ASIC to provide better outcomes to consumers, through further work to address concerns regarding design, selling practices and supervision.

ASIC's review of add-on insurance

In 2016 ASIC released three reports relating to the sale of add-on insurance products sold through car dealers:

- Report 470 Buying add-on insurance in car yards: Why it can be hard to say no (**REP 470**)
- Report 471 The sale of life insurance through car dealers: Taking consumers for a ride (**REP 471**)
- Report 492 A market that is failing consumers: The sale of add-on insurance through car dealers (**REP 492**)
  (copies provided with this submission)

ASIC's reports found that add-on insurance products sold through car dealers provide significantly poor outcomes for consumers. ASIC called for life and general insurers distributing these products to address the high costs, poor value and poor claims outcomes, to ensure these products deliver value to consumers and are sold appropriately.

REP 492 focused on the sale of general insurance products in this market and made six findings relating to the design, value and distribution of these products (see the Appendix for a summary of these findings and ASIC's response).

One of ASIC's findings was that, over a three year period, the insurers in our review paid $602.2 million in commissions to car dealers and only $144 million to consumers in claims. This means car dealers earned four times more in commissions than consumers received in claims. ASIC's response to this finding was that insurers needed to:

- reduce the commissions and financial benefits payable to car dealers; and
- pass on the entirety of the savings from lower commissions to consumers through lower premiums.

On behalf of its members, the Insurance Council of Australia (**ICA**) put forward a range of proposals to address our findings.[1] These proposals were broadly categorised as pricing[2] and non-pricing proposals. The proposal submitted to the ACCC for authorisation specifically addresses ASIC's finding in relation to commissions paid to car dealers.

The failure of competition in the add-on insurance market

ASIC's finding that the car dealer add-on insurance market is benefitting the distributors of the products more than it benefits the consumers, indicates that competition in this market is not operating effectively and that it is failing consumers. ASIC has explored the reasons why this is occurring, through our own research and through engagement with a variety of stakeholders.

[1] Insurers propose enhancements to add-on insurance products, ICA, 12 September 2016
[2] Two of ASIC's findings specifically related to pricing concerns, and a further finding related to poor claims ratios, which can be improved through a combination of pricing, distribution and product design improvements.

A key reason ASIC identified for this market failure is the existence of 'reverse competition'. In this market reverse competition means that insurers compete with each other on the price paid to car dealers in commissions in order to access distribution channels, which increases the cost to consumers and decreases consumer-driven competition. Insurers have acknowledged that there is a first mover disadvantage - if one insurer decides to reduce the commissions paid to the distributor, there is a risk that they will lose market share.

We note that the effect of reverse competition in the add-on insurance market has been a long-standing issue. In Australia its impact was identified as early as 1991, with a review by the former Trade Practices Commission (TPC) finding that competition tended to take the form of insurers increasing consumer credit insurance delivery costs (including agents' commissions), rather than reducing premiums.[3]

The TPC review, and other subsequent reports on the CCI market, proposed a number of recommendations, such as improved training and supervision, and changes to disclosure. Those recommendations have clearly failed to deliver better consumer outcomes, and demonstrate the need for alternative interventions.

Potential impact of cap

In principle, ASIC supports a cap on commissions to help address the concerns identified in REP 492 that consumers are paying too much for add-on insurance sold through the car dealer channel, in part due to very high commissions.

Public benefit - addressing market failure and consumer outcomes

A voluntary cap on commissions paid to motor vehicle dealers in this market, if implemented with appropriate controls and transparency, has the potential to address the market failure of reverse competition and to result in better consumer outcomes.

In REP 471 and REP 492 ASIC analysed the value of premiums paid by consumers, compared to the value returned to consumers in claims (known as the 'claims ratio'). The claims ratio is an important indicator of the value consumers derive from an insurance product. The Financial Conduct Authority (FCA) in the United Kingdom has also used claims ratios as a value measure for add-on insurance products, as a simple and effective way to 'compare from the consumer perspective, what is paid in against what is paid out in claims'.[4]

REP 492 found that add-on insurance products sold through car dealers have extremely low claims ratios, reflecting poor value for consumers (see table below). A reduction in commissions paid to car dealers, where the entirety of the savings from lower commissions is passed on to consumers through lower premiums, can result in a substantial improvement to the claims ratio, reflecting improved value to consumers.

The table below shows the maximum upfront commissions paid to car dealers by the insurers in our review, and the impact that a 20% cap could have on the claims ratio where the savings are passed on to consumers. We note that the maximum commissions in this table only

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[3] Trade Practices Commission, *The market for consumer credit insurance*, June 1991, p. 61.

[4] Market Study MS14/1, General insurance add-ons: Final report—Confirmed findings of the market study, FCA, July 2014.

capture upfront commissions, while the proposed cap would also capture volume bonuses and other financial incentives. Five of the seven insurers in our review offered volume bonuses, most commonly with GAP insurance, in which case the impact on the claims ratio will be even greater.

Product	Maximum commission	Current claims ratio	Claims ratio with 20% cap
CCI (business use)	50%	7.2%	10.3%
GAP insurance	72%	6.3%	13.1%
Loan termination insurance	50%	4.4%	6.3%
Tyre and rim insurance	65%	8.6%	15.6%
Mechanical breakdown insurance	79%	22%	53.7%

While the estimated claims ratios with the 20% cap do not necessarily reflect good value for the consumer, it is evident that the imposition of a cap could have a direct impact on improving consumer outcomes, in some cases more than doubling the current value. ASIC sees this as one part of a range of ongoing work that will improve the value of these products for consumers (discussed further in 'Other regulatory action', see page 7).

As part of the proposal, insurers have proposed that they will, *"report to ASIC on a number of metrics designed to quantify the effectiveness of the cap on reducing premiums and increasing loss ratios for insurance products sold through the motor vehicle dealership channel"*. This data reporting will assist ASIC to consider further regulatory responses to this issue, if needed.

At this stage, ASIC does not propose to set target ratios for individual products or across all add-on products under consideration. However, in line with our expectations that insurers have oversight over the value/outcomes their products are delivering for consumers, we expect that insurers should develop target claims ratios that they consider are consistent with delivering fair outcomes and good value for consumers. We expect firms to monitor their performance against these targets and to keep them under review on an ongoing basis (discussed further in 'Other regulatory action', see page 7).

Other impacts

ASIC has identified a number of potential impacts of the proposal, based on submissions by made to the ACCC, engagement with stakeholders, and our own research and discussions. The table below details these features, potential impacts, and ASIC's consideration of these matters.

Some of these features raise concerns about possible avoidance practices. We consider that these possible practices should be examined and addressed, in order to ensure that the voluntary proposal by the insurance industry is effective and responds to the issues identified

by ASIC. It would be undesirable for the proactive steps of industry seeking to respond to the issues to be undermined by conduct designed to avoid the effect of the commission cap.

Feature of current proposal	ASIC's response
Does not capture all instances of the sale of these products (e.g. motor vehicle leases are not captured)	It is important that the 20% cap is comprehensive in its application to the sale of add-on insurance products in order to deal with potential avoidance practices. For instance if add-on insurance products were to be promoted more heavily through alternative channels, including sale to consumers entering into motor vehicle leases, rather than sales. In REP 492, we note that *"While this report focuses on concerns with the car dealer distribution channel, many of our findings have a broader application to add-on insurance products sold through other channels."* While ASIC has not conducted specific research relating to add-on products sold with motor vehicle leases, the impact of high commissions is likely to decrease consumer value in the same way that we have identified in the market for car sales. There is a risk that a cap on commissions for add-on insurance sold with a purchased vehicle, but not on a leased vehicle, could have an impact on how cars are sold to consumers, with an increased distribution of these products through the leasing market.
Comprehensive car insurance is captured	As part of our review, ASIC did collect data on comprehensive insurance products, however in REP 492 we note that *"…we excluded this product from our report as it did not raise the same concerns about value for consumers. Because comprehensive insurance is a product which consumers are more likely to seek out, insurers offered more competitive pricing for these products and claims outcomes for consumers were better."* The application of the cap to comprehensive car insurance may not offer any additional public benefit, as consumer-driven competition appears to already take place for these products. However, we do note the potential for transference if a particular insurance product is excluded from the cap, which could result in increased commissions being paid on that product, and cross subsidisation with other insurance products, due to the cap imposed on other products. This is particularly relevant as the way that add-on insurance products are sold to consumers as part of the sale of the motor vehicle means that consumers' ability to make informed decisions is reduced. This may mean that consumers will be less price sensitive for comprehensive insurance than when buying it through other channels, e.g. shopping around online at renewal time.

Feature of current proposal	ASIC's response
Application of the cap to intermediaries, namely brokers and underwriting agents.	The distribution chain for an add-on insurance product may include other intermediaries involved in the design, sale and administration of the product. For instance, the insurer may 'underwrite' the insurance product for an agency which develops the product features and markets and distributes the product to motor vehicle dealers. It has been suggested that the 20% commission cap should not include remuneration for these intermediary services. ASIC considers that that the 20% cap should be comprehensive in its application to add-on insurance products, irrespective of the distribution chain behind the sale. Most significantly, the consumer's primary concern is the end retail premium they pay. In that sense, any additional costs of distribution, whether reasonably incurred or not, will potentially reduce the value of the product. A broad application of the commission cap therefore creates incentives on firms to deliver efficiency and good value throughout the distribution chain. In addition, applying the cap to intermediated chains also reduces the risks of avoidance. For example, in relation to credit brokers who sell add-on insurance products directly to consumers (outside of the car dealer market, for example when organising credit for a car loan), the impact of high commissions is likely to decrease consumer value in the same way that has been seen in the car dealer channel. Additionally, if the cap did not apply to finance brokers, there is the potential that these products will begin to be more heavily distributed by insurers through these channels. In practice, because the 20% commission available would have to be shared between a number of firms in intermediated chains this might make such models less attractive and impact on the feasibility of some firms' business models. The impact on participants in this market should be balanced with an assessment of the overall efficiency of distribution and benefit received by consumers in the form of competitive premiums. A broadly applied cap does place greater onus on insurers to understand the end retail price products are sold for, and consider what value such intermediaries and distributors they contract with are providing. This is because the insurer will need to consider the overall 20% cap when contracting with other parties. We consider that this is in line with good governance/business practice. While some stakeholders have suggested that this will subsequently increase barriers to entry to the add-on insurance market, the cap on commissions has the potential to increase competition, as insurers do not have to compete in paying high commissions in order to access distribution channels. This should lead to competition on premium and product features.
No monitoring and enforcement mechanism in the application.	We understand that a breach of the cap on commissions will constitute a breach of the voluntary code of practice that insurers will subscribe to when agreeing to implement the cap. We consider that an effective code of practice includes monitoring and compliance procedures and that there would be consequences for a breach of the code requirements. ASIC's guidance on industry codes is set out in Regulatory Guide 183 which sets out our guidance on best practice standards for voluntary industry codes.

Feature of current proposal	ASIC's response
The 20% cap has been proposed as a solution, even though the legislative 20% cap on CCI has not resulted in these products providing better value to consumers.	ASIC sees a cap on commissions as one part of a range of ongoing work that will improve the value of these products for consumers. The cap has the potential to provide substantially improved outcomes for consumers, particularly where measures such as transparent data reporting are implemented to ensure that the reduction in commissions is being passed on to consumers via reduced premiums. In addition to this, ASIC is continuing a range of other work to address the other findings of REP 470, REP 471 and REP 492, particularly in relation to sales practices and product design. This ongoing work will apply to CCI products, where the legislative 20% cap is already in force. The cap on commissions is one important aspect of providing more valuable products to consumers, in combination with other regulatory and industry-led solutions.

Other regulatory action

Based on submissions by other parties to the ACCC, and ASIC's engagement with stakeholders, we are aware of a range of other suggestions as alternatives to the cap for improving consumer value of add-on insurance products, for example:

- Banning single premium policies, given the consequent increase in cost and that it inhibits the development of a more competitive market by locking the consumer into a product with the same insurer for the term of the policy (which could be seven years for a CCI policy);
- Unbundling the sale of the add-on insurance from the sale of loans, to address some of the consumer behaviours that occur when add-on insurance is sold at the same time as the primary product, including decision fatigue, information overload and anchoring[5]; and
- A ban on the sale of life and trauma insurance in dealerships, as the consumer will either not need this cover (for example, if they are single with no dependants) or need more comprehensive cover (to cover all their debts and provide a replacement for lost future income).

We note that these alternative or additional measures relate to findings by ASIC in REP 470, REP 471 and REP 492, however they do not relate specifically to ASIC's findings on high commissions and the way in which this increases cost and decreases value for consumers. The 20% cap that has been proposed more directly addresses this particular finding.

While the details of ASIC's ongoing work is confidential, we are aware that improvements to product design and distribution are extremely important in improving consumer outcomes, and we are continuing to work with insurers while also pursuing other regulatory options in order to address these issues. As noted in REP 492, one aspect of this work will be to consult with individual insurers and seek information on their individual target claims ratios, as well as progress made against delivery. However, without a cap on commissions, ASIC will be limited in its ability to drive improvement in claims ratios and consumer outcomes in this market.

[5] Report 470, Buying add-on insurance: Why it can be hard to say no, ASIC, February 2016, p 10.

Appendix: REP 492 key findings and ASIC's response

<table>
<tr><th>Finding</th><th>Explanation</th><th>ASIC’s response</th></tr>
<tr><td>Finding 1: Consumers receive low claim payouts relative to premiums</td><td>Across all add-on insurance products we reviewed, over a three-year period, the gross amount paid in claims was $144 million, or only 9% of gross premiums of just over $1.6 billion.

The claims ratio for the two products with the highest dollar value in sales were even lower:
• for GAP insurance, 6.3 cents in the dollar was paid back in claims (with total claims of $39.9 million, and premiums of $631.1 million); and
• for CCI, covering both general and life insurance components, 5 cents in the dollar was paid back in claims (with claims of $25.3 million, and premiums of $506.8 million).</td><td>Insurers must deliver better value products with significantly improved claims ratios.

We will consult with each insurer and seek information on their individual targets.

If we consider increases in claims ratios are inadequate, we will consider steps such as public disclosure of claims ratios to increase the visibility of these poor outcomes.</td></tr>
<tr><td>Finding 2: Consumers receive much less in claims than dealers received in commissions</td><td>Upfront commissions of up to 79% of the premium were paid to car dealers arranging the sale of add-on insurance products.

Insurers paid $602.2 million in commissions to car dealers and only $144 million to consumers in claims. This means car dealers earned four times more in commissions than consumers received in claims.

This is illustrated in the two products with the highest dollar value for the 2015 financial year:
• for GAP insurance, dealers earned 8.2 times more than consumers ($328.8 million in commissions against $39.9 million in claims); and
• for CCI, dealers earned 3.8 times more than consumers ($97.2 million in commissions against $25.39 million in claims).</td><td>Insurers must:
• reduce the commissions and financial benefits payable to car dealers; and
• pass on the entirety of the savings from lower commissions to consumers through lower premiums.</td></tr>
<tr><td>Finding 3: Lack of price competition results in poor consumer outcomes</td><td>Dual pricing was common—four general insurers charged premiums to business use consumers that were higher than the prices charged to personal-use consumers (where commissions are capped under the National Credit Code).</td><td>Insurers must abandon pricing arrangements where the consumer can pay more for the same cover for reasons unrelated to the underlying risk (e.g. because the car dealer can earn higher commissions by arranging for the consumer to pay a higher premium).</td></tr>
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Finding	Explanation	ASIC's response
	Discretionary pricing meant that some consumers paid nearly 10 times more for the same product, with two insurers giving car dealers discretion to vary the price that can be charged for add-on insurance.	
Finding 4: Insurers sell products that are poorly designed	Many add-on products were poorly designed, so that consumers were often paying for something they did not need or that offered poor value. *Negative or low-value policies* in some cases meant that the average claim was less than or similar to the average premium paid: • *for mechanical breakdown insurance*, the average claim was only 63.4% of the average premium ($940 against $1482); and • *for tyre and rim insurance*, the average claim was only 80.4% of the average premium ($334 against $414). Other examples included: • *overlapping cover,* where some CCI policies bundle components of cover together, such as trauma and disability cover, in a way that appears to provide overlapping cover for certain claimable events, while each type of cover attracts a separate cost to the consumer; and • *unnecessary cover*, such as mechanical breakdown insurance, which can be unnecessary as statutory consumer guarantees under the Australian Consumer Law require the dealer and manufacturer to meet the cost of repairs if the car is not of an acceptable quality.	Insurers must redesign their policies to ensure they provide cover in circumstances that can be reasonably expected to meet the needs of their customers. Insurers must take immediate steps to stop the continued sale of policies where cover is unnecessary or overlaps with other cover. This includes identifying classes of transactions where their products should not be sold (e.g. gap insurance where there is no gap) and preventing car dealers from selling products in those circumstances.

Finding	Explanation	ASIC's response
Finding 5: Single premium policies increase the cost for consumers	The practice of having consumers pay for insurance upfront in a single premium can contribute to poor outcomes, including: • *interest costs,* which the consumer will pay if they finance the premium through their car loan, reducing the value of the product; • *reduced consumer awareness*, as the consumer pays for the policy in a lump sum at the start of the policy and may forget they have it; and • *no refunds of unused premium*, which means a consumer may pay for insurance cover they do not receive as their insurance policy will terminate if they pay out their car loan early, further reducing the value of holding cover through these products.	Insurers should not sell single premium policies. Insurers who continue to do so will face continued focus from ASIC. Single premiums lead to reduced claims and reduced consumer awareness and the risk of not getting a premium refund for paying out a car loan early. Poor consumer outcomes produced by single premium policies outweigh any potential consumer convenience. Monthly instalment premiums should be affordable and not 'loaded' to take account of increased claims due to increased consumer awareness.
Finding 6: Sales processes inhibit good decision-making	The sales process adopted by insurers lacked adequate controls, was complex and inhibited good or informed decision-making: • *GAP insurance* represented poor value to consumers, in that what they will receive back in a claim depends on the market value of the car reducing at a faster rate than the car loan so that a 'gap' exists and is payable in the event of a claim, which may not occur; • *complex product choices* were offered to consumers (e.g. up to 10 products with multiple choices of cover available—the maximum from one insurer was 224 different product options and cover levels); • *the full cost of the premium was frequently not disclosed to consumers* before the sale even though they were required to pay for the insurance upfront (some insurers gave a fortnightly or monthly figure); and • *exclusions or eligibility criteria* were not discussed, with most sales scripts only presenting the benefits of the product (e.g. only two scripts addressed the need to alert consumers about meeting the eligibility criteria for unemployment insurance).	Insurers must redesign their sales practices taking into consideration: • behavioural biases and the consequent poor consumer outcomes identified in this report and REP 470 and REP 471; • failings identified in this report, including failure to provide adequate information about the price of products and the options within each product before the consumer makes a purchasing decision; and • sales models that would better allow consumers to make informed choices (e.g. a deferred sales model). Insurers must proactively audit and identify unfair sales practices, with appropriate consequences for misconduct including clawback of commissions and termination for repeated or serious failures.