The "Trowbridge Report"

A blueprint for change or another chapter in a never ending story?

Insurance

April 2015

Will it lead to changes in NZ?

The "Trowbridge Report" was published in Australia at the end of March. It is available here: http://www.afa.asn.au/newsadvocacy/policy-regulatory-change The report calls for major changes to the life insurance advice sector in Australia. While it's still early days, the view is growing that the report is going to drive major changes there.

The recommendation in the report gaining most attention is the "Reform Model" for adviser remuneration ie after a 3yr transition period, upfront commission (renamed an "initial advice payment") will be limited to 60% of the first year's premium (capped at $1,200) and level commissions limited to 20%. So that's 80% in year 1 and 20% thereafter.

Is the report a blueprint for change, as reported in the Australian media, or will it be another chapter in the never ending story in the debate on upfront commissions? We think it might actually be the former – upfront commissions look like they are going to be limited in Australia, it's just a matter of how much and when. Will NZ follow suit?

Background to 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 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. Following the ASIC report the 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 an 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.

An interim report was due in mid-December 2014 and the final report, early in 2015. The interim report was duly released in December. However at the same time the ASIC report's findings were surpassed by the Financial System Inquiry report, the "Murray Report", which was also published in December 2014, one week before the interim report. 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. As a result the Trowbridge report became even more timely and important.

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

Simpl House 40 Mercer Street
PO Box 11330 Wellington 6142 New Zealand
T: 64 4 499 0277
wgtn@mjw.co.nz

www.mjw.co.nz
MELVILLE JESSUP WEAVER LIMITED

57 Fort Street
PO Box 4014 Auckland 1140 New Zealand
T: 64 9 300 7155
akld@mjw.co.nz

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. The recommendations as set out in the report are attached as an appendix to this newsletter. There are 6 policy recommendations, 4 implementation recommendations and 1 review recommendation.

Adviser remuneration

Policy Recommendation 1. The proposals are:

- Level commission, with a maximum of 20% of premiums;
- An Initial Advice Payment (IAP) to be paid to an adviser of 60% of the first year's premium capped at $1,200;
- The IAP is payable no more than once every 5 years and is on a per client basis. Fees for service can be agreed outside of (and on top of) the IAP and commission;
- The IAP is only payable on advised business where there was personal advice;
- All commission and any other incentive payments to be fully disclosed to the client;

Collectively these terms are referred to as the "Reform Model" and are to apply from 2018.

The IAP is deliberately intended to fall short of full cost recovery for advisers.

The financial impact of the proposals is expected to be a reduction in premium rates of between 5% and 10%.

Policy Recommendation 2 is for 3 a year transition to the Reform Model. During this period:

- The 5 year rule commences on a best endeavours basis ASAP (June 2015?);
- From a date in 2016 the maximum initial commission is 80% (capped at $8,000) and the maximum renewal commission is 20%; and
- This 80/20 is counted under the 5 year rule.

Licensee remuneration

Policy Recommendation 3 is that advisers be prohibited from receiving benefits from insurers that might influence the products offered to a client. Examples of non-commission benefits are volume overrides, payments for business equipment and services and shares in an insurer.

The report however suggests a maximum Licensee Support Payment (LSP), which cannot be passed onto advisers, of 2% of premiums in force.

Implementation Recommendation 1

This recommendation is the means to effect Policy Recommendations 1 to 3. The report concludes that the best way to implement them is for ASIC to amend conditions of licence for insurers to include the 3 recommendations.

Choice of insurer

Policy Recommendation 4 is particular to the Australian regulatory environment but is very significant. The recommendation is that advisers should have at least half of the licenced insurers included in their Approved Product List (APL). There are 13 licenced retail life insurers in Australia.

Policy Recommendations 5 and 6

The remaining 2 Policy Recommendations are around adviser and insurer culture and behaviour. The first is specific to advisers and includes the associated documentation advisers provide. The second calls for a Life Insurance Code of Practice for life insurers modelled on the General Insurance Code of Practice.

Implementing the recommendations

The report makes 4 recommendations on implementing the report's Policy Recommendations. Interestingly for the first 4 policy recommendations to take effect they will need statutory backing and the report requests ASIC incorporate them into licensing conditions. The other changes can be driven by advisers and the industry.

The final recommendation is for a review to be conducted in 2020 to assess the effectiveness of the changes.

Response to the report

When the review was set up, the aim was to have a co-ordinated and unified report but this has proved difficult to achieve. What has been reported to date through the media is the position that the FSC (the insurers) in general support the report while AFA (the advisers) have rejected it. Much has been made of the proposed remuneration not properly covering upfront the cost of providing advice (deliberate by Trowbridge to reduce churn) and as a consequence the number of advisers in the industry is projected to fall[1]. Interestingly the AFA has also said "*Our interpretation of the recommendations is that they will do more to resolve the sustainability issues of insurers…*"

1 http://www.afa.asn.au/afanews/afa-statement-consumers-to-lose-access-to-quality-advice

The Government response seems to be led by Josh Frydenberg, the Federal Assistant Treasurer, who wrote the following in the AFR: "*Wide-ranging and well informed, Trowbridge's report does not shy away from confronting the difficult issues facing the life insurance industry. The report is likely to represent the last chance for the industry to address these longstanding issues on its own terms. While Murray's Financial Systems Inquiry and the Trowbridge Report provide the Government with a number of options for reform. The extent to which Government intervention is required will depend ultimately on the industry's own actions. It is up to the industry now to restore public confidence before time for industry leadership runs out*."

He has subsequently been reported as saying at a FSC event in Sydney "*Appropriate reform, made as soon as possible, must be led by the industry itself. Industry should not force the heavy hand of Government to act*." and "*I'm not saying many months – they* [the industry] *don't have months – I'm saying weeks and maybe at most a couple of months*".

We understand the FSC has formed a committee, which has already met, to implement the first 3 recommendations.

NZ industry response

So where does that leave NZ? Commission rates in NZ are considerably higher than the 130% rates talked about in Australia while lapse rates are of a similar magnitude. Do we have a similar problem or is in fact, the problem that ASIC was trying to solve in Australia, worse in NZ?

This debate is nothing new and has been ongoing for decades. On one level it can be argued that it is about the sustainability of advisers versus the sustainability of insurers as acknowledged in the AFA statements to date. This fundamental tension prevents the alignment of interests between customers, advisers and insurers – the very thing Trowbridge was attempting to solve. Are the Trowbridge recommendations a blueprint for change as they seem to be becoming regarded as in Australia? Does that blueprint transfer to NZ?

We note the FMA made mention of the subject of insurance sales in its Strategic Risk Outlook 2015. Included in the FMA's seven key areas of focus is the aim that sales processes and advisory services reflect the best interests of investors and consumers. It identifies 3 specific areas of focus:

- Address the mis-selling of financial products;
- Registered financial adviser conduct; and
- Review of the Financial Advisers Act.

Under the first item while it first highlights whether investors receive the proper advice when they switch their balances between KiwiSaver providers it also mentions mis-selling of insurance products, including selling products that do not meet the customer's needs, and churning of products to customers.

So it is quite likely that we will see some interest from the authorities in NZ, and if Australia can arrive at an agreed model that would achieve the aims of the FMA, it would potentially be easy to adopt it over here.

The key question then becomes, if something like the proposed Australian model is adopted here, what will the impact be on the industry? Will it provide the existing players the opportunity to have a fresh look at how they distribute their products and allow them to tap new distribution channels and bring the benefits of life insurance to a wider audience? At the same time it may create opportunities for potentially new players?

STOP PRESS

It seems AMP have taken the first step to adopt the Trowbridge recommendations:

http://www.professionalplanner.com.au/cut-and-paste/2015/04/29/amp-announces-life-insurance-reforms-36269/

ABOUT MELVILLE JESSUP WEAVER	*For further information please contact:*
Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The firm was established in 1992 and has offices in Auckland and Wellington. The firm is an alliance partner of Towers Watson, a leading global professional services company.	**David Chamberlain** *(04) 830 0117* David.Chamberlain@mjw.co.nz
	Linda Caradus *(04) 815 8889* Linda.Caradus@mjw.co.nz

Appendix – Trowbridge Report Recommendations

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. **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. **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	**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.
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.	**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.
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.	**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.
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.	**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.
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.	