2016-2017-2018-2019

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (UNFAIR TERMS IN INSURANCE CONTRACTS) BILL 2019

EXPLANATORY MEMORANDUM

(Circulated by authority of the Treasurer)

Table of contents

Glossary.......... 1

General outline and financial impact.......... 3

Chapter 1 Extending the Unfair Contract Terms Regime to Insurance Contracts.......... 4

Chapter 2 Statement of Compatibility with Human Rights.......... 17

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
FSRC	Financial Services Royal Commission
ASIC	Australia Securities and Investments Commission
Insurance Contracts Act	*Insurance Contracts Act 1984*
UCT regime	Unfair contract terms regime found in sections 12BF-12BM of the ASIC Act.
Duty of the utmost good faith	Duty of the utmost good faith found in sections 12-15 of the *Insurance Contracts Act 1984.*

General outline and financial impact

Overview

Schedule 1 to the Bill gives effect to recommendation 4.7 of the FSRC to extend the existing protections of the UCT regime under the ASIC Act to insurance contracts governed by the Insurance Contracts Act.

Date of effect: The amendments commence 18 months after the Bill receives Royal Assent. The UCT regime will apply to insurance contracts made or varied after the commencement date.

Proposal announced: The Government announced that it would extend the UCT regime to insurance contracts on 4 February 2019 as part of its response to the FSRC.

Financial impact: Nil

Human rights implications: This Bill does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 2.

Compliance cost impact: The Regulation Impact Statement for this reform assesses that compliance costs for insurers are likely to be low. It is estimated that there will be upfront costs of under $4 million in the first year to implement the reform with no ongoing costs for insurers.

Chapter 1
Extending the Unfair Contract Terms Regime to Insurance Contracts

Outline of chapter

1.1 This Chapter provides an overview of the amendments in Schedule 1 to the Bill to extend the existing protections of the UCT regime under the ASIC Act to insurance contracts governed by the Insurance Contracts Act.

Context of amendments

1.2 Many businesses use standard form contracts to engage with consumers. These contracts generally set out terms on a 'take it or leave it basis' which means consumers are unlikely to be able to negotiate with the business if they believe elements of their standard form contract are unfair.

1.3 To address this problem the UCT regime was introduced in 2010 to protect consumers from unfair contractual terms in standard form contracts. A term in a relevant standard form consumer contract is void if it is unfair. The rest of the contract continues to bind the parties if it is capable of operating without the unfair term. A court can declare that a term in a relevant standard form consumer contract is unfair on application by a party to the contract or ASIC. The court's ability to do this does not limit its ability to make other declarations which may include declarations that the term would be unfair across all of a business's similar standard form contracts. The regime was extended to small business contracts in 2016. However insurance contracts covered by the Insurance Contracts Act have always been specifically excluded from the UCT regime.

1.4 A range of government and independent inquiries since 2010 have recommended that the UCT provisions should be extended to insurance contracts, including:

- Recommendation 4.7 of the FSRC in 2019;[1]

[1] Page 308 of Volume 1 of the FSRC Final Report.

- Recommendation 6 of the Australian Competition and Consumer Commission first interim report in the Northern Australia Insurance inquiry in 2018;[2]
- Recommendation 3.1 of the 2018 Parliamentary Joint Committee on Corporations and Financial Services inquiry into the life insurance industry;[3]
- Recommendation 11 of the 2017 Senate Economics Committee Inquiry into the general insurance industry;[4] and
- Proposal 10 of the 2017 Australian Consumer Law Review.[5]

1.5 Following the 2017 Senate Economics Committee Inquiry into the general insurance industry, the Government announced it would extend the UCT regime to insurance contracts.[6] In June 2018, the Government published a proposals paper outlining a potential model for extending the regime.[7]

1.6 In February 2019, the FSRC recommended applying the UCT provisions in the ASIC Act to contracts regulated under the Insurance Contracts Act. The FSRC also recommended adjusting the regime in its application to insurance contracts by defining the main subject matter for insurance contracts as the terms of the contract which describe what is being insured.[8] The government agreed to implement this recommendation in full.[9]

1.7 The FSRC also noted that over-prescription and excessive detail in legislation can undermine regulation. Such detail can shift responsibility for behaviour away from regulated entities and result in a 'box-ticking' approach, rather than ensuring they comply with the fundamental norms of behaviour that should guide their conduct. The FSRC considered that a clearer focus on those fundamental norms in the primary legislation and subordinate instruments will improve the regulatory architecture and ensure that the intent of the law is met.

1.8 The government agreed, wherever possible, to simplify the financial services law to eliminate exceptions and qualifications to the law

[2] Page 151 of the ACCC Northern Australian Insurance Inquiry First Interim Report.

[3] Page 49 of the 2018 Parliamentary Joint Committee on Corporations and Financial Services inquiry into the life insurance industry Final Report.

[4] Page 65 of the 2017 Senate Economics Inquiry into the general insurance industry Final Report.

[5] Page 53 of the 2017 Australian Consumer Law Review Final Report.

[6] Pages 4-5 of the Government Response to the 2017 Senate Economics Committee Inquiry into the general insurance industry.

[7] Extending Unfair Contract Terms Protections to Insurance Contracts, June 2018.

[8] Page 308 of Volume 1 of the FSRC Final Report.

[9] Page 25 of the Government Response to the FSRC Final Report.

(recommendation 7.3 of the FSRC). This Bill removes one such exemption.

1.9 The government also agreed to identify the norms of behaviour and principles that underpin legislation as part of the legislative simplification process (recommendation 7.4 of the FSRC).

1.10 The norm underlying this Bill is that insurers should not include terms in their standard form contracts that are unfair to the other party.

Summary of new law

1.11 There are two key components in the Bill.

1.12 Firstly, the Bill amends the Insurance Contracts Act to enable the UCT regime under the ASIC Act to apply to insurance contracts covered by the Insurance Contracts Act.

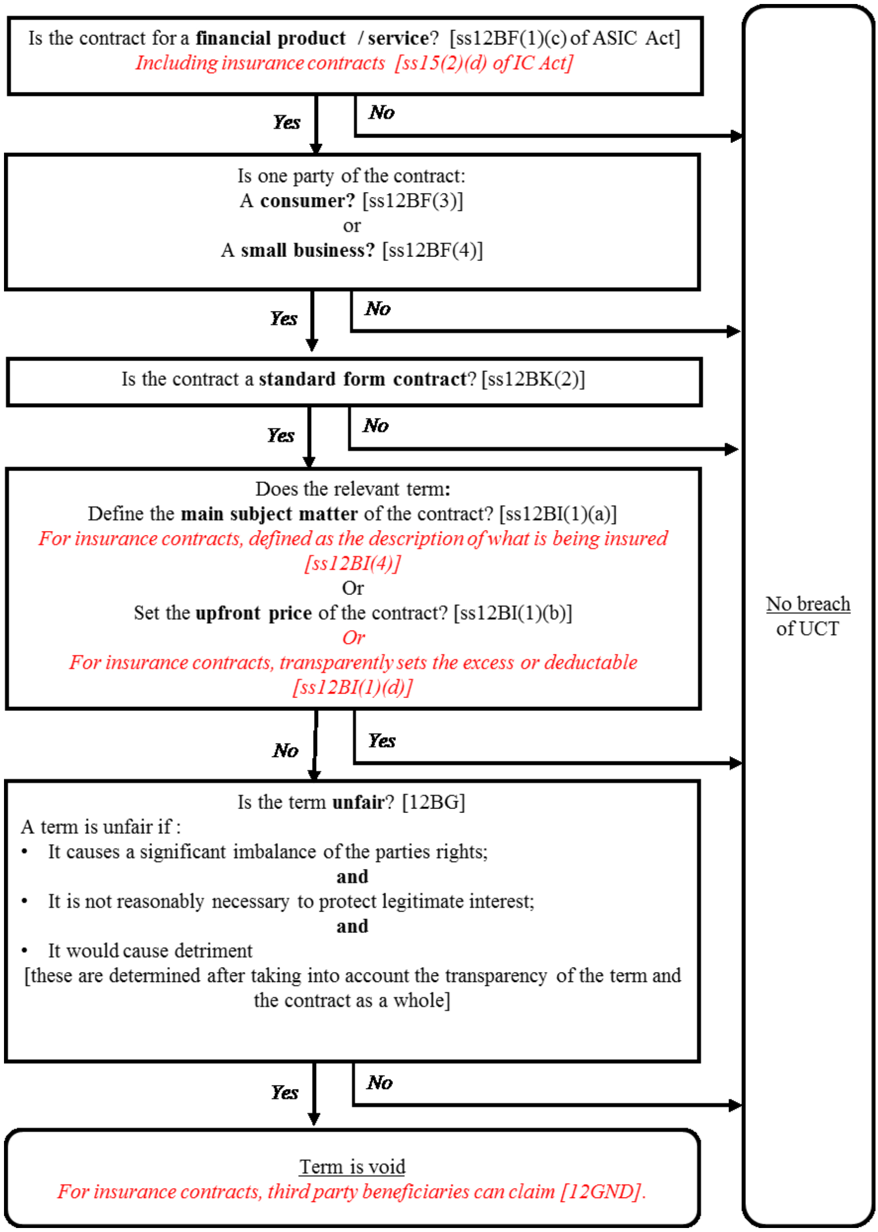
1.13 Secondly, the Bill amends the ASIC Act to tailor the existing UCT regime in its application to insurance contracts. These changes are listed below:

- **Main subject matter**: The ASIC Act presently excludes terms that define the main subject matter of a contract from the UCT regime. The Bill will amend the ASIC Act to provide that the main subject matter of an insurance contract is limited to the description of what is being insured.
- **Transparent excess terms**: The Bill will amend the ASIC Act to exclude terms that set the quantum or existence of the excess or deductible in an insurance contract from the UCT regime, as long as they are presented transparently.
- **Third party beneficiary**: The Bill will amend the ASIC Act to allow for third party beneficiaries of insurance contracts to bring actions against insurers under the UCT regime.

1.14 Under the Insurance Contracts Act parties to insurance contracts have an obligation to act with the utmost good faith. The Bill does not impact this obligation, with the duty of the utmost good faith operating independently of the UCT regime.

1.15 Diagram 1.1 provides a high level summary of the operation of the UCT regime, with changes made by this Bill highlighted with italics.

Diagram 1.1 Summary of the operation of the UCT regime for financial products and services[10]



[10] Note: A separate UCT regime operates under the National Consumer Law for non-financial products.

Comparison of key features of new law and current law

New law	*Current law*
The UCT regime will apply to insurance contracts covered by the Insurance Contracts Act.	Insurance contracts covered by the Insurance Contracts Act are excluded from the UCT regime.
Terms that define the main subject matter of an insurance contract will be excluded from the UCT regime. However terms defining the main subject matter of an insurance contract will be limited to terms which define what is being insured (e.g. a house, a car, a person).	Terms that define the main subject matter of a contract are excluded from the UCT regime. Main subject matter is not defined in the Act.
Terms defining the upfront price payable of an insurance contract will continue to be excluded from the UCT regime.	Terms defining the upfront price payable under a contract are excluded from the UCT regime. The upfront price payable under contract is the consideration under a contract that is disclosed at the time the contract is entered into.
Terms defining the quantum or existence of the excess or deductible of an insurance contract will be excluded from the UCT regime if they are disclosed upfront and are transparent.	The UCT regime does not apply to insurance contracts covered by the Insurance Contracts Act.
Third party beneficiaries of an insurance contract covered by the regime will be able to bring a claim under the UCT regime. Third parties to other kinds of contracts will continue to be unable to bring claims.	The UCT regime does not allow third party beneficiaries to bring a claim.
The duty of the utmost good faith will continue to apply to insurance contracts concurrently with the UCT regime.	The duty of the utmost good faith applies to insurance contracts.

Detailed explanation of new law

Allowing the UCT regime to apply to insurance contracts

1.16 Section 15 of the Insurance Contracts Act currently prevents insurance contracts being made subject to relief under any other Commonwealth Acts on the grounds that the contract is harsh, oppressive, unconscionable, unjust, *unfair* or inequitable.

1.17 To allow the UCT regime to apply to insurance contracts, section 15 of the Insurance Contracts Act is amended to enable relief relating to the UCT regime in section 12BF of the ASIC Act to apply to insurance contracts ***[Schedule 1, item 8, subsection 15(2)]***.

Applying the current UCT regime to insurance contracts

1.18 The central elements of the existing UCT regime will apply to insurance contracts. The amendments provide that the UCT regime applies to insurance contracts covered by the Insurance Contracts Act where:

- at least one party to the contract is a consumer (as defined in subsection 12BF(3) of the ASIC Act) or a small business (as defined in subsection 12BF(4) of the ASIC Act); and
- the contract is a standard form contract (as defined in section 12BK of the ASIC Act).

1.19 An insurance contract will still be a standard form contract even if a consumer can choose between several options such as levels of premium, excess or sum insured as long as the consumer does not have the ability to negotiate the underlying terms and conditions governing the contract (see subsection 12BK(2) of the ASIC Act for all criteria for determining whether a contract is a standard form contract).

1.20 Similarly, an insurance contract can still be a standard form contract if it is intermediated by a broker as long as the circumstances of the case meeting the criteria in subsection 12BK(2) of the ASIC Act for determining whether a contract is a standard form contract.

Example 1.1

Matthew is a consumer wishing to purchase home and contents insurance. He requests a broker to recommend the best insurance policy. The broker, acting for Matthew, seeks contracts from several insurers. The contracts are prepared by the insurer, do not take into account Matthew's specific characteristics and the broker does not negotiate on Matthew's behalf. As such, the contracts would be considered standard contracts and Matthew, as the party to the contract, can bring action under the UCT regime.

Example 1.2

> BBB Limited is a small business seeking professional indemnity insurance. BBB Limited requests a broker to recommend the best insurance policy. The broker, acting for BBB Limited, seeks quotes from several insurers. In preparing the contracts, the broker negotiates specific clauses due to the nature of BBB Limited's business. As such, the contract is not considered a standard form contract and BBB Limited, as the party to the contract, cannot take action under the UCT regime.

1.21 If an insurance contract is subject to the UCT regime, a term in that insurance contract may be declared unfair and therefore void. A term is considered unfair if it meets all three criteria in section 12BG of the ASIC Act which currently apply to general contracts. As such, a term would be unfair if it:

- would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- is not reasonably necessary in order to protect the legitimate interests of the party that would be advantaged by the term; and
- would cause detriment to a party if it were to be applied or relied on.

1.22 Section 12BH sets out examples of terms which could be unfair. These examples are product-neutral and are equally applicable to insurance. Further examples of terms which could be unfair in the insurance context include:

- a term that allows the insurer to, instead of making a repair, elect to settle the claim with a cash payment calculated according to the cost of repair to the insurer, rather than how much it would cost the insured to make the repair;
- a term in a contract that is linked to another contract (for example a credit contract) which limits the insured's ability to obtain a premium rebate on cancelation of the linked contract; or
- a term that would allow the insurer to require the insured to pay an excess, before the insurer pays the claim.

1.23 While it is ultimately a matter for the Court to determine whether a term is unfair, many terms in insurance contracts will be reasonably necessary to protect the legitimate interests of the insurer. For example, a term in a life insurance contract that allows an insurer to unilaterally increase premiums would not be considered unfair if that term was used to protect the legitimate interests of the insurer in response to a change in the actuarial pricing of risk required to underwrite the policy.

1.24 Section 12BI of the ASIC Act prevents some terms in a contract from being considered unfair, including the main subject matter of the contract, the upfront price payable and any term required by a law of the Commonwealth or a State Government.

1.25 The main subject matter of a contract is undefined in the current law. For insurance contracts, the main subject matter will be defined (see below).

1.26 The upfront price payable under a contract is currently defined in subsection 12BI(2) of the ASIC Act. This definition will apply to insurance contracts, meaning that the insurance premium paid, as long as it meets the criteria of subsection 12BI(2) of the ASIC Act, cannot be considered unfair. See below for a discussion of excesses and deductibles in insurance contracts.

1.27 Section 12BF of the ASIC Act provides that a term in a relevant standard form consumer contract is void if it is unfair. However, if there is a dispute as to whether a term is unfair, the parties or ASIC can seek a declaration from the court under section 12GND of the ASIC Act that the contractual term is unfair. The court's ability to do this does not limit its ability to make other declarations which may include declarations that the term would be unfair across all similar standard form contracts held by a business. This will also be the case for insurance contracts. The only difference will be that in the case of insurance contracts, third party beneficiaries will also have the right to seek the court's declaration that a contractual term is unfair (see below).

1.28 Subsection 12BF(2) of the ASIC Act provides that an insurance contract will continue to bind the parties if it is capable of operating without the unfair term. This will also be the case for insurance contracts.

Changes made to the UCT regime in its application to insurance contracts

1.29 The ASIC Act is amended to tailor the application of the general UCT regime to insurance contracts. This is in recognition of the unique characteristics of insurance contracts.

Main subject matter of an insurance contract

1.30 Terms defining the main subject matter of any financial product or service contract are excluded from the UCT regime by section 12BI of the ASIC Act. The exclusion of terms that define the main subject matter of a standard form contract ensures that a party cannot challenge a term concerning the basis for the existence of the contract. This is in recognition of the fact that the party had a choice whether or not to enter the contract on the basis of what was offered.

1.31 In line with FSRC recommendation 4.7, for insurance contracts the main subject matter will be limited to the extent that the term describes what is being insured. For example, the house, car, or person that is insured. ***[Schedule 1, item 4, subsection 12BI(4) of the ASIC Act].***

1.32 Where a term describes what is being insured and is the basis for the existence of the contract, that term is the main subject matter of the contract and is not subject to the unfair contract regime. For example:

Example 1.3

Isla purchases home insurance for a house at 17 Drayton Street. The policy describes the house as a four bedroom, brick veneer freestanding house. This description (a four bedroom, brick veneer freestanding house at 17 Drayton Street) is the main subject matter of the contract and is not subject to the unfair contract regime.

Example 1.4

Jess purchases car insurance. The policy describes the car as a 2018 Kia Carnival S 2.2-litre four-cylinder turbo-diesel with a modification to take wheelchairs. This description (a 2018 Kia Carnival S 2.2-litre four-cylinder turbo-diesel with a modification to take wheelchairs) is the main subject matter of the contract and is not subject to the unfair contract regime.

1.33 The FSRC considered that the benefits of extending the UCT regime to insurance contracts would be undermined if a broader definition of main subject matter were adopted.

Transparent excess and deductible terms exclusion

1.34 Under current law, a term setting out the upfront price that is payable under a contract is excluded from the UCT regime (see section 12BI of the ASIC Act). However the definition of upfront price payable does not encompass the excess or deductible of an insurance contract due to the exclusion from that definition of any consideration that is contingent on the occurrence or non-occurrence of a particular event. This means that terms setting the quantum or existence of any excesses or deductible of an insurance contract are subject to UCT obligations and may be considered unfair.

1.35 Excesses and deductibles are similar, but slightly different types of terms under an insurance contract. Excesses are an amount contributed by the insured when making a claim under an insurance contract. Deductibles are an amount deducted from a payment made by an insurer as a result of a claim under an insurance contract. Both excesses and deductibles can be directly related to the upfront price of an insurance contract. A high upfront premium and a lower excess or deductible can be equivalent to a lower upfront premium and a higher excess or deductible. Subjecting excesses and deductibles to the UCT regime may simply result in insurers offering lower excesses and deductibles and higher premiums, which is not the policy intent.

1.36 Excesses and deductible terms should be subject to the UCT regime if they do not form the basis for the existence of the contract. Excesses and deductibles which the insured chooses to increase or decrease as part of the contract (with resulting premium changes) should not be subject to challenge. However, excesses or deductibles that do not form the basis for the existence of the contract should be subject to the UCT regime. As such, only terms that are transparent to the insured at the time of purchasing the contract are not subject to challenge under the UCT regime.

1.37 As such, the ASIC Act is amended so that a term in an insurance contract which sets out the quantum or existence of the excess or deductible payable under an insurance contract will be excluded from the UCT regime if the term is transparent (as defined in subsection 12BG(4) of the ASIC Act). ***[Schedule 1, item 3, subsection 12BI(1) of the ASIC Act].***

Example 1.5

> James renews his car insurance for a 2014 IS300 Lexus, paying a $500 premium. A 'basic' excess of $1000, payable when any claim is made, was clearly presented in the quote and also on the renewal notice. The quantum of the excess ($1000) is not subject to challenge under the UCT regime.

Third party beneficiaries

1.38 Under the existing UCT regime in the ASIC Act a court can only declare that a term is unfair on application by a party to the contract or ASIC (See subsections 12GND(1) and (2)).

1.39 Third party beneficiaries of insurance contracts are recognised in the Insurance Contracts Act as having the ability to bring actions under that Act. This is because there are circumstances where they will be required to take action in the place of the contracting party. The Bill amends the ASIC Act to allow third party beneficiaries of insurance contracts to also bring actions against insurers under the UCT regime ***[Schedule 1, item 5, paragraphs 12GND(1)(c) and (d)]*.**

- For example death benefit nominees under a life insurance policy or individuals covered under certain group insurance policies (e.g. a policy purchased by small sporting associations on behalf of club members to cover personal injury incidents) are likely to be able to bring actions under the UCT regime in relation to contracts covered by the regime.

1.40 Third party beneficiaries are defined in the Insurance Contracts Act as a person who is not a party to the contract but is specified or referred to in the contract, whether by name or otherwise, as a person to whom the benefit of the insurance cover provided by the contract extends (section 11 of the Insurance Contracts Act).

1.41 The definitions of consumer and small business (section 12BF), tests of unfairness (section 12BG of the ASIC Act) and definition of standard form contracts (section 12BK of the ASIC Act) continue to relate to the *parties* to the insurance contract, not third party beneficiaries. This means that while third party beneficiaries can bring actions, the actions will only be successful if the tests of unfairness (section 12BG of the ASIC) and standard form contracts (section 12BK of the AISC Act) are met with reference to the parties that negotiated the contracts, not the third party beneficiaries.

- For example, a contract for insurance purchased on a group basis by a large superannuation trustee would likely not be covered by the regime. A superannuation trustee would be unlikely to meet the definition of a small business or consumer, and is likely to have significant bargaining power in negotiating such contracts so the contract would not meet the definition of a standard form contract.

The Duty of the Utmost Good Faith

1.42 The Insurance Contracts Act provides that parties to an insurance contract have a duty to act with the *utmost good faith* (see Part 2 of the Insurance Contracts Act). The duty covers any matters in relation to the insurance contract including negotiation before the contract is signed and claims handling after a contract has been formed. The amendments in the Bill do not impact the existing operation of the duty of utmost good faith.

1.43 The Insurance Contracts Act and ASIC Act have been amended to include notes to make it clear that the UCT regime and the duty of utmost good faith operate independently of one another. ***[Schedule 1, Item 2, section 12BF of the ASIC Act and item 7, section 12 of the Insurance Contracts Act]***

1.44 A breach of the duty of the utmost good faith will not necessarily equate to a breach of the UCT regime. A breach of the UCT regime will not necessarily equate to a breach of the duty of the utmost good faith. Each regime operates independently of the other. However it is possible that some scenarios may give rise to relief under both sets of provisions. In such scenarios, a party may bring actions before the court under either or both regimes, and the court will be able to take into account the concurrent operation of the two regimes when considering what orders to make.

Application and transitional provisions

1.45 The UCT regime will apply to new insurance contracts from the date of commencement of Schedule 1 to the Bill. Schedule 1 to the Bill will commence 18 months after the date of Royal Assent. Contracts which are renewed or varied after the commencement of Schedule 1 to the Bill will also be covered by the UCT regime. ***[Schedule 1, item 6, section 324 of the ASIC Act, and item 9 of the Bill]***

Chapter 2
Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019

2.1 This Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.2 The Bill extends UCT regime in the ASIC Act to apply to insurance contracts under the Insurance Contracts Act.

Human rights implications

2.3 The Bill does not engage any of the applicable rights or freedoms.

Conclusion

2.4 The Bill is compatible with human rights as it does not raise any human rights issues.