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05 April 2018

Hon Kenneth Hayne AC QC
Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

By email: FSRCmedia@royalcommission.gov.au

Dear Commissioner

We submit the contents of this document as evidence for the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Maurice Blackburn has been a willing contributor to many public inquiries into elements of the financial services industry, and we would be pleased to make previous submissions and case studies available to the Royal Commission.

We would also be pleased to appear before the Royal Commission to present our evidence, answer questions and provide suggestions for industry improvement.

Please do not hesitate to contact me and my colleagues on (02) 8267 0977 or at JMennen@mauriceblackburn.com.au if we can further assist with the Royal Commission's important work.

Yours faithfully

Josh Mennen
Principal
MAURICE BLACKBURN

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Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

April 2018

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Introduction

Maurice Blackburn Pty Ltd is a plaintiff law firm with 31 permanent offices and 29 visiting offices throughout all mainland States and Territories. The firm specialises in personal injuries, medical negligence, employment and industrial law, dust diseases, superannuation (including Financial Advice Disputes), negligent financial and other advice, and consumer and commercial class actions.

Maurice Blackburn employs over 1000 staff, including approximately 330 lawyers who provide advice and assistance to thousands of clients each year. The advice services are often provided free of charge as it is firm policy in many areas to give the first consultation for free. The firm also has a substantial social justice practice.

Our Superannuation and Insurance and Financial Advice Disputes practice has represented and assisted thousands of claimants for over 20 years. We have the largest practice of its kind in Australia and currently have approximately 125 staff nationally working in the team.

At any one time we provide legal assistance to approximately 3500 to 4000 clients. Much of this work is assisting them with the complex and challenging processes involved in making an insurance claim under their superannuation scheme membership or retail insurance policy. Our team also provides comprehensive advice and representation in cases involving the often egregious and negligent advice provided by financial advisors.

On a daily basis we witness the difficulties experienced by our clients when unexpected illness or injury forces them out of the workforce, and we also see the devastating impact of unfair decision making by life insurers. We witness as well the ramifications of rogue financial advisors who can create significant financial hardship in our clients' lives.

Executive Summary

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission) has been a long time coming. For years, scandal after scandal has rocked the sector, progressively eroding the public's trust in banks and other financial services institutions and causing untold damage to consumers.

When caught out, the institutions have been quick to blame 'rogues' or 'bad apples', denying systemic or cultural failings, with upper management denying responsibility.

As lawyers, we have seen our clients' trust betrayed by these institutions on numerous occasions.

We are pleased to submit the contents of this document as evidence for the Royal Commission on behalf of the many clients of Maurice Blackburn who have been personally affected by the actions of some of Australia's largest and most powerful corporations.

Despite the breadth of topics captured by the Terms of Reference for the Royal Commission, we have limited our input to three areas of concern for our clients, being:

i. The adequacy of the current regulatory regime in the life insurance industry;

ii. The provision of a compensation scheme of last resort safety net for consumers; and

iii. The need for regulatory reform in the mortgage lending market.

In each of these three topics, we have attempted to outline:

- the core issue(s),
- the historical events that enabled these issues to manifest,
- the current circumstances requiring investigation,
- case studies which demonstrate the human face or lived experience of the issue, and
- recommended courses of action.

Each of our responses directly addresses one or more of the Terms of Reference of the Royal Commission, specifically:

> *1(f): the adequacy of:*
> > *i. existing laws and policies of the Commonwealth (taking into account law reforms announced by the Government) relating to the provision of financial services;*
> > *ii. the internal systems of financial services entities; and*
> > *iii. forms of industry self-regulation, including industry codes of conduct;*
>
> *to identify, regulate and address misconduct in the industry, to meet community standards and expectations and to provide appropriate redress to consumers and businesses;*
>
> *1(g) the effectiveness and ability of regulators of a financial services entity to identify and address misconduct by those entities;*
>
> *1(h) whether any further changes to:*
> > *i. the legal framework;*
> > *ii. practices within financial services entities; and*
> > *iii. the financial regulators,*
>
> *are necessary to minimise the likelihood of misconduct by financial services entities in future (taking into account any law reforms announced by the Government).*

Above all, we urge the Royal Commission take a victim-focused approach to collecting evidence and developing its much anticipated recommendations.

Summary of Recommendations

With specific reference to Term of Reference 1(f)(iii), Maurice Blackburn submits:

1. That the Royal Commission review the extent to which the life insurance industry is failing to comply with the Life Insurance Code of Practice.
2. That the Royal Commission review the effectiveness of the structure and substance of the Life Insurance Code of Practice and the Insurance in Superannuation Voluntary Code of Practice.
3. That the Royal Commission make recommendations in relation to Codes of Practice that reflect those made by the Parliamentary Joint Committee on Corporations and Financial Services into the Life Insurance Industry in its report of March 2018, specifically recommendations 4.1 - 4.4 inclusive.
4. That the Royal Commission recommend that an enforceable code(s) regulating life insurers and trustees of regulated superannuation funds be developed in line with Australian Securities and Investments Commission (ASIC) Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct, including a requirement for ASIC approval and enforceability of robust sanctions.
5. That the enforceable code(s) be contractually binding between trustees of regulated superannuation funds and life insurers by consumers.
6. That the enforceable code(s) be developed through an open and transparent process, involving genuine consultation with both community representatives, advocates and industry groups.
7. That the enforceable code(s) enshrine standard cover definitions including the definition of total and permanent disability as reflective of 'permanent incapacity' at section 1.03C of the *Superannuation Industry (Supervision) Act* (SIS) regulations, namely:
   "*a member of a superannuation fund or an approved deposit fund is taken to be suffering permanent incapacity if a trustee of the fund is reasonably satisfied that the member's ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training or experience".*
8. That the enforceable code(s) set out to protect consumers and clearly spell out the remedies and sanctions which apply for a breach of the code(s).
9. That the enforceable code(s) regulate the conduct of insurance companies and regulators in assessing claims:

   - It should agree to the fair and reasonable exchange of documentation relied upon in assessing claims,
   - It should include clear time frames, with clearly articulated remedies for a breach of this requirement,
   - Claims should be assessed in a timely manner and avoid excessive delays.
   - Any delays in assessing claims due to their complexity should be agreed between the parties, and
   - Any claim that is not assessed within a reasonable period of time after an internal complaint is lodged should be assessed in line with ASIC Regulatory Guide 165.

10. That an enforceable code(s) as described above would be preferable to a legislated solution.

11. That the Royal Commission look to effectively disincentivise delay in life insurance claim assessment, through applying scrutiny to claim delay and withdrawal rates with regard to the ‘penalty interest verses investment return’ conflict.

12. That the Royal Commission recommend extending Unfair Contracts Terms (UCT) laws to cover general and life insurance contracts.

With specific reference to Term of Reference 1(f), (g) and (h), Maurice Blackburn submits:

13. That there is a need for a right of direct recourse by consumers against an insolvent tortfeasor’s PI insurer through the newly established Australian Financial Complaints Authority (AFCA). This would substantially reduce the costs burden on the Compensation Scheme of Last Resort (CSLR).

14. That the Royal Commission refer to the newly introduced *Civil Liability (Third Party Claims Against Insurers) Act 2017* (NSW) section 4, which reads:

    “If an insured person has an insured liability to a person (the claimant), the claimant may, subject to this Act, recover the amount of the insured liability from the insurer in proceedings before a court.”

    We submit that these laws represent the benchmark for facilitating a fair and effective direct recourse regime.

15. That legislation such as the above differs greatly between jurisdictions, and warns that this may lead to ‘forum shopping’ amongst consumers seeking justice and recourse.

16. That it should be a condition of licencing that Financial Service Providers’ (FSP) Professional Indemnity (PI) insurers are registered and contractually bound by External Dispute Resolution (EDR) decisions in relation to which the PI insurer is on risk.

17. That Australian Financial Complaints Authority (AFCA) should be required to maintain a register detailing the insurance providers and amounts of cover of all registered FSPs.

18. That, at the very least, all EDR schemes should include the name and details of the relevant past and current PI insurers in their registers of FSP Members.

19. That AFCA be obliged to re-open complaints lodged with the Credit & Investments Ombudsman (CIO) (and Financial Ombudsman Service (FOS) if applicable) from 2008 which CIO declined to determine on the basis that the FSP had ceased trading to allow a consumer to obtain a determination for submission to the Compensation Scheme of Last Resort.

In relation to the establishment of a Compensation Scheme of Last Resort (CSLR), Maurice Blackburn submits:

20. That a scheme be established.

21. That all claims that would come within the jurisdiction of an ASIC approved EDR scheme (including AFCA) should be prima facie eligible for consideration under a CSLR. This would typically include claims for breach of contract, negligence and statutory breach against a provider of financial services. It would also include unsuitable loans under the Credit Law, and unjust contracts under the *National Consumer Credit Protection Act* (2009) (NCCP Act) in respect to which FOS and CIO currently have jurisdiction.

22. That it is reasonable to expect that consumers, in attempting to access a CSLR must:

    - Have proof of an attempt to take a dispute to EDR which was unsuccessful because the FSP is not a Member, or
    - Have proof in the form of a determination from a Court, Tribunal or EDR scheme in the consumer's favour.

    The lodgement of a Proof of Debt with a liquidator should also be considered as a pre-requisite, particularly where the FSP is no longer a Member of an EDR scheme or cannot be sued without special leave.

23. That a CSLR should include rights to recover the full financial impact, although the capacity of the firm to pay could be an issue. We believe that the ability to pursue the directors of such firms would prevent phoenix behaviour occurring.

In response to Terms of Reference 1(f)(i) and 1(h)(i), Maurice Blackburn submits:

24. That section 178(2)(b) of the *National Consumer Credit Protection Act* (2009) (NCCP Act) be amended to clarify that causes of action run from the date that the losses are realised in accordance with the principles espoused in *Wardley Australia Ltd v State of Western Australia* (1992) 175 CLR 514.

25. That section 116(2) of the *Bankruptcy Act* (1966) – the section which lists the exclusions from the property divisible among creditors – be expanded to include property which is subject to a cause of action under the NCCP Act against a creditor.

Our Submission

The adequacy of the current regulatory regime in the life insurance industry

The Issue:

Premium increases, tightening eligibility definitions and overzealous claims handling processes within the life insurance industry have threatened the fairness and sustainability of what is a crucially important financial product for underinsured Australian households. Attempts at self-regulation have been underwhelming, with the Life Insurance Code of Practice (FSC Code), adopted in July 2017, already being widely flouted by those it is designed to regulate.

The Historical Context:

In the late 2000s, group life insurance providers were eagerly vying to provide life and Total and Permanent Disability (TPD) policies for superannuation funds looking to offer low cost default cover for their members.

Despite a number of warnings from the Australian Prudential Regulation Authority (APRA)[1], group life insurers were slow to accept that significant price reductions combined with softer underwriting practices and enhancements to benefits would ultimately affect profitability.

Post global financial crisis (GFC), an unparalleled 'claims lump' led to unbudgeted payouts, culminating in a profits nose dive across the industry in 2013. Greater consumer awareness of the existence of entitlements embedded in their superannuation scheme, a tightening employment market and an increase in mental health claims are widely accepted as the drivers of the spike in claims.[2]

The immediate response by industry was to increase premiums in an attempt to recover losses, and to tighten policy terms to make it tougher for claimants to claim against their policy. Some of the manifest behaviours which typified this tightening included:

- The slide towards 'junk' insurance policies, characterised by unreasonable thresholds and definitions. For example, some insurers began adopting the term 'incapable ever' or 'unable ever' instead of 'unlikely' to provide a threshold for whether a claimant might ever work again. We are aware of one policy which lists 115 occupation categories, which are all assessed under the highly onerous Activities of Daily Living test. This is contrary to the *Superannuation Industry (Supervision) Act* 1993 Act permanent incapacity definition for early release.

- The treatment of legacy claims from the 'claims lump' as a predictor of all claims going forward rather than as a temporary increase in claim numbers, thereby inflating premium increases.

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[1] *See section on Life Insurance Industry Overview www.apra.gov.au/Insight/Documents/14-Insight-Issue-2.pdf from p.4*

[2] *See for example: APRA's Submission to the Senate Economics Committee Inquiry into the Scrutiny of Financial Advice–Life Insurance https://www.aph.gov.au/DocumentStore.ashx?id=790eec66-f56a-4f2f-96d3-8eb6a8f65114&subId=412976; http://www.ricewarner.com/breathing-life-back-into-disability-insurance/; https://www.finder.com.au/life-insurance-premium-increase*

- An unwillingness to recognise the right of members to access legal representation in a claim. Insurers instead blamed lawyers for premium increases because they drew claimants' attention to their potential benefits.

- Barriers created through unreasonable delays in processing claims, along with barriers created within the complex application forms and process.

- The use of techniques designed to prolong and frustrate the claims process. These included surveillance, (multiple) independent medical examinations, activity diaries, requests for information in a 'drip feed' fashion and open ended general authorities. These techniques led to high levels of withdrawn claims, particularly for mental health claimants.

- A move toward incremental payments rather than lump sum TPD payments, requiring claimants to undergo ongoing medical and other checks over a period of years. For example, Sunsuper for their TPD Assist policy (effective 1/7/16) pays the lump sum over five years, requiring the claimant to reapply each year. This often deprives seriously ill and injured people the opportunity to effectively retire debt and pay for much needed medical treatment.

Importantly, this reaction by insurers failed to fundamentally address any of the structural or cultural issues which led to the 2013 losses.

ASIC's 'Report 498: Life Insurance Claims: An Industry Review' [3] found that whilst there was broad divergence across the reviewed life insurers' statistics, three (de-identified) life insurers had TPD decline rates above 25% between 2013 and 2015 [4] and three life insurers had withdrawn claim rates of 20% or more in the same period [5]. Delay, the provision of information and non-disclosure were identified as disproportionately high common issues for mental health claims.

The Current Situation:

The FSC's Life Insurance Code of Practice[6] (the Code) commenced on 1 July 2017 and requires FSC members to:

- Make a decision within 6 months from lodgement on all claims other than income-related claims, including TPD claims[7]; and

- Provide a final response to the complaint within 45 days if the policy is not part of a superannuation fund, or 90 days if the policy is part of a superannuation fund [8].

The Code also says that: "*For applications, claims or complaints that already exist on the date we are bound by the Code, if the Code requires us to do something within a specified timeframe, that timeframe begins on the date we are bound by the Code*".[9]

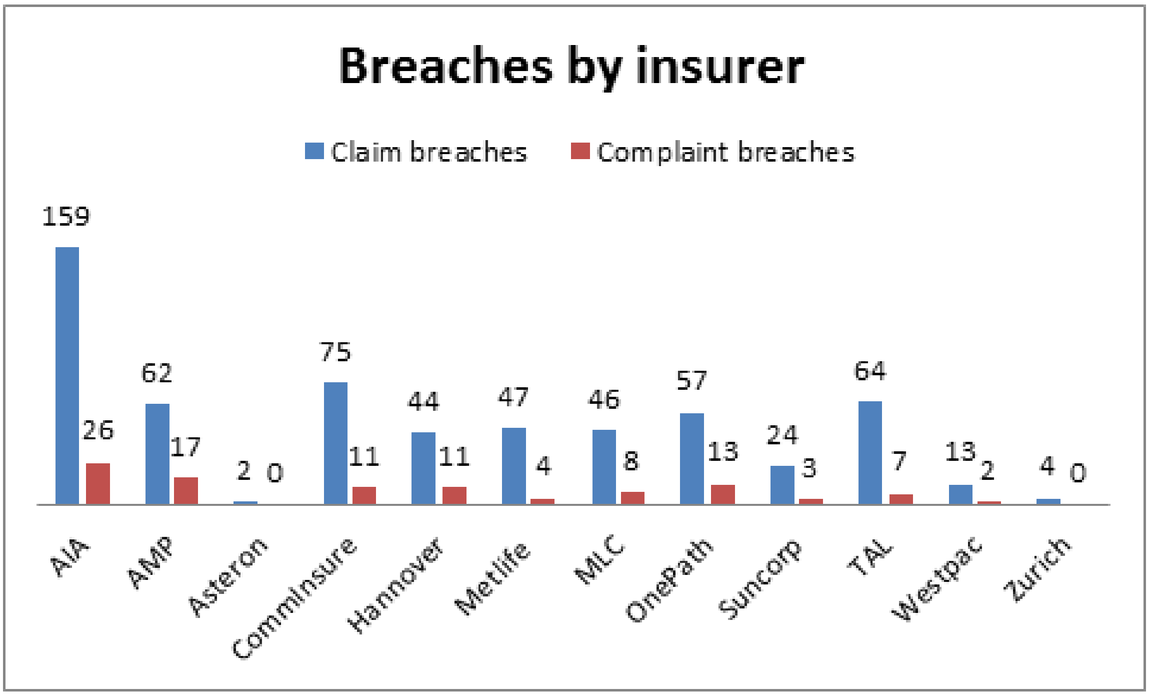
Despite the Code having only been in effect since 1 July 2017, Maurice Blackburn has already seen voluminous breaches with respect to the time taken to make decisions on

[3] http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-498-life-insurance-claims-an-industry-review/
[4] Ibid, see Figure 8, p.48
[5] Ibid, see Figure 16, p.57
[6] https://www.fsc.org.au/policy/life-insurance/code-of-practice/life-code-of-practice.pdf
[7] Ibid clause 8.17, p.18
[8] Ibid clause 9.10 (p.20) and clause 9.12 (p.21)
[9] Ibid. Refer to the footnote to clause 2.9 (p.3)

claims. We have recently reported over 700 alleged breaches as a bulk complaint to the Life Code Compliance Committee, which is industry-funded and administered by the Financial Ombudsman Service (FOS)[10].

Figure i displays a graph detailing this bulk complaint, including the insurers responsible for these alleged claim and complaint breaches. As previously stated, the large numbers of reported breaches cited in this graph represent only cases from Maurice Blackburn's case load at a particular point in time since the inception of the Code, but the volume of these breaches shows the very significant and broader problem in ensuring adherence to the Code. We continue to see a failure from insurers to communicate properly in offering an explanation or remedy when breaches occur.

Figure i Breaches by insurer



Maurice Blackburn also notes that AIA's market leadership in the life insurance market is reflected in these figures. Given that they have also recently acquired CommInsure, which is also facing a significant number of breach allegations, we are concerned that AIA may have mounting systemic issues to face in its claims processing culture.

It is concerning that on the rare occasions where an insurer does address the prima facie delay code breach (rather than simply ignore it which is what generally occurs) it often misuses the 'Unexpected Circumstances' clause in the Code to afford itself a further open ended period of time. For example we have seen an insurer claim that a request for Medicare records made more than a year after the lodgement of the claim constituted a legitimate trigger that invokes the 'Unexpected Circumstances' clause.

Maurice Blackburn notes that ASIC's Report 498: Life Insurance Claims: An Industry Review[11] identified delay as a major cause of disputes (particularly for mental health

[10] *See https://www.smh.com.au/politics/federal/disabled-australians-waiting-for-insurance-claim-decisions-look-to-royal-commission-for-help-and-hope-20180208-p4yzqz.html*

claims).[12] A clear consequence of delay is that a claimant who is overburdened by the process may withdraw their claim. Indeed, the same report found that two insurers had high withdrawn retail claim rates of 34% and 29%[13].

Unreasonable delay is supposed to be penalised through section 57 of the *Insurance Contracts Act* 1984. However the above ASIC findings and the alleged breaches of the Code described above demonstrate that it is not working as an effective disincentive.

A key reason is that life insurers can and do invest their assets for returns that well exceed the penalty interest rate. For example, APRA's Quarterly Life Insurance Performance Statistics[14] stated that "*Annualised return on net assets for the industry was 10.9% in the December quarter of 2017*". Compare that to penalty interest which is currently around 5.58%[15].

Plainly, the interest payable for unreasonable delay does not represent an actual penalty to a life insurer. Indeed, insurers remain financially incentivised to delay claims for as long as possible even where they are required to pay interest. That is an unacceptable situation and it remains a major moral hazard for insurers until the statutory interest rate for claim delays is significantly greater than the investment returns an insurer enjoys on its capital reserves.

Maurice Blackburn submits that it is appropriate that the Royal Commission apply scrutiny to claim delay and withdrawal rates with regard the above penalty interest verses investment return conflict and look to effectively disincentivise delay in life insurance claim assessment.

Maurice Blackburn fears that the recently released Insurance in Superannuation Voluntary Code of Practice[16] (ISV Code) covering trustees or regulated superannuation funds, lacks the regulatory wherewithal to significantly impact such trends. At a high level, it displays the following stark deficiencies:

- Its allows trustees who do decide to sign up with the discretion to opt out of any specific aspects of the ISV Code[17];
- It is not contractually binding;
- It has no code administrator to enforce it and relies upon self-reported breaches;
- It has no ASIC approval or oversight;
- It has a surprisingly long transition period for compliance (2021);
- It imposes no higher claims assessment standards than those set out in the deficient FSC Code to which it notionally binds participating trustees[18];
- It is not compliant with ASIC Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct [19].

Maurice Blackburn believes that the above issues demonstrate the industry's reticence to change.

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[11] *http://download.asic.gov.au/media/4042220/rep498-published-12-october-2016a.pdf*
[12] *See for example ibid paragraph 208 (p.62)*
[13] *Ibid. See Figure 14, p.55*
[14] *http://www.apra.gov.au/lifs/Publications/Documents/1802-QLIPS-20171231.pdf (p.5)*
[15] *https://www.fos.org.au/publications/practice-notes/application-of-interest/*
[16] *http://aist.asn.au/media/1099546/insurance_in_superannuation_voluntary_code.pdf*
[17] *Ibid, clause 3.11 (p.3)*
[18] *ibid clause 7.11 (p.13)*
[19] *http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-183-approval-of-financial-services-sector-codes-of-conduct/*

Maurice Blackburn notes the outcomes of the Parliamentary Joint Committee on Corporations and Financial Services' recent inquiry into the Life Insurance Industry[20], and in particular their recommendations in relation to voluntary codes, namely:

- *Recommendation 4.1*
  The committee recommends that the government implement the co-regulatory approach put forward in the ASIC Enforcement Review Taskforce Position Paper across the whole financial services sector, while ensuring, where possible, that there are no exemptions for any part of the life insurance industry and that codes are written in plain English.

- *Recommendation 4.2*
  The committee recommends that ASIC be given the power to undertake enforcement action (halting misconduct, remedies and sanctions) in relation to systemic or systematic breaches of codes of practice in the financial services sector, including in the life insurance sector.

- *Recommendation 4.3*
  The committee recommends that, in order for ASIC to approve any code of practice in the financial services sector, including life insurance, the code must apply to all relevant industry participants, without exemptions.

- *Recommendation 4.4*
  The committee recommends that, prior to seeking ASIC approval, the two codes of practice for the life insurance industry be combined into a single code of practice if possible.

Maurice Blackburn submits that the Royal Commission should look to make similar recommendations to those of the Parliamentary Joint Committee.

Maurice Blackburn also notes that the Parliamentary Joint Committee devoted considerable attention to the issue of extending Unfair Contracts Terms (UCT) laws to cover general and life insurance contracts [21].

Maurice Blackburn is pleased to support the Consumer Action Law Centre's well-argued position in support of this point and note that they have advocated for this for some time[22].

As noted in their report[23]:

"*Current consumer protections in insurance include:*

- *the duty of utmost good faith for insurers and their customers, which is part of every insurance contract but provides little practical benefit to individuals,*
- *anti-discrimination laws, which have limited application to insurance,*
- *restrictions on insurers denying claims based on an insured person's actions,*
- *limits on insured people's duties to insurers, and*
- *disclosure obligations on insurers*." (p.3)

[20] *https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/LifeInsurance/~/media/Committees/corporations_ctte/LifeInsurance/report.pdf (p. xvi)*
[21] *Ibid, refer section 3.23, p.34*
[22] *https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/02/180111_Denied_Digital-Report.pdf*
[23] *Ibid, p.3*

The report goes on to note that[24]:

"*Under Australia's current unfair contract terms laws, a term is unfair if it ticks three boxes:*

- *It would cause a significant imbalance in the parties' rights and obligations*
- *It is not reasonably necessary to protect the legitimate business interests of the advantaged party (the trader), and 3. It would cause financial or other detriment to the individual if it were applied or relied on".*(p.23)

Maurice Blackburn submits that, overall, extending UCT laws to cover general and life insurance contracts would ensure that all insurance contract terms pass the fairness test.

This position was also broadly recommended in the PJC report at recommendation 3.1 and 3.2. We urge the Royal Commission to adopt similar recommendations.

The Human Face:

<u>Case study #1:</u>

> *Maurice Blackburn is assisting a client in his late twenties who in 2012 was involved in a motorbike accident and suffered multiple serious fractures. He continues to suffer with shoulder, hip and back injuries, and with ongoing pain and physical restrictions. He had been working as an Assistant Business Manager for a large retail chain at the time. The client has income protection and TPD insurance with AMP/AIA through his employer's superannuation scheme. His income protection claim was accepted in 2015, and three years was back paid. The salary continuance however was stopped in 2016 and his TPD claim was rejected, with AMP alleging he could return to work with restrictions. His employer has been unable to find the client alternative work for this purpose.*
>
> *The client has now issued court proceedings in Victoria regarding his claim, and as at January 2018 there had still been no response to his internal complaint which was lodged in September 2016 (to which AIA was required by the Code to respond to within 90 days from July 2017).*

Case study #1 is an example of insurers' failure to comply with the timelines the industry has set for itself in the FSC Code; timelines the FSC has extraordinarily termed "aspirational"[25].

<u>Case study #2:</u>

> *Maurice Blackburn is assisting a client in her mid-40s, who was diagnosed with MS in 2002. She has not worked since 2007 due to the severity of her MS symptoms. The client has group insurance via her Super Fund for TPD, and she is insured for $175,000. Her claim was lodged in April 2015, and has now been ongoing without a decision for almost three years. In total, 12 letters have been sent to the Fund (Vision Super) since September 2015 seeking updates on the claim, including a formal complaint regarding the delay.*
>
> *Vision Super are not an FSC member and are therefore not signed up to the FSC Code as they are a self-insured trustee.*

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[24] Ibid, p.23

[25] *See comment of Nick Kirwan of the FSC: https://www.smh.com.au/politics/federal/disabled-australians-waiting-for-insurance-claim-decisions-look-to-royal-commission-for-help-and-hope-20180208-p4yzqz.html*

Case study #2 highlights the inadequacy of having these two separate codes, neither of which may apply as is the case for this client. Specifically, trustees like Vision Super who self-insure may avoid any compliance obligations as they are not required to sign up to either the FSC (as they are not a life insurance company) or the ISV Code which is voluntary.

Our Submission:

With specific reference to Term of Reference 1(f)(iii), Maurice Blackburn submits:

1. That the Royal Commission review the extent to which the life insurance industry is failing to comply with the FSC Life Insurance Code of Practice.

2. That the Royal Commission review the effectiveness of the structure and substance of the FSC Code and the ISV Code.

3. That the Royal Commission make recommendations in relation to Codes of Practice that reflect those made by the Parliamentary Joint Committee on Corporations and Financial Services into the Life Insurance Industry in its report of March 2018, specifically recommendations 4.1 - 4.4 inclusive.

4. That the Royal Commission recommend that an enforceable code(s) regulating the life insurers and trustees of regulated superannuation funds be developed in line with ASIC Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct, including a requirement for ASIC approval and enforceability of robust sanctions.

5. That the enforceable code(s) should be contractually binding between trustees of regulated superannuation funds and life insurers by consumers.

6. That the enforceable code(s) be developed through an open and transparent process, involving genuine consultation with both community representatives, advocates and industry groups.

7. That the enforceable code(s) enshrine standard cover definitions including the definition of total and permanent disability as reflective of ‘permanent incapacity’ at section 1.03C of the SIS regulations, namely:
   “*a member of a superannuation fund or an approved deposit fund is taken to be suffering permanent incapacity if a trustee of the fund is reasonably satisfied that the member’s ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training or experience”.*

8. That the enforceable code(s) set out to protect consumers and clearly spell out the remedies and sanctions which apply for a breach of the code(s).

9. That the enforceable code(s) regulate the conduct of insurance companies and regulators in assessing claims:

   - It should agree to the fair and reasonable exchange of documentation relied upon in assessing claims.
   - It should include clear time frames, with clearly articulated remedies for a breach of this requirement.
   - Claims should be assessed in a timely manner and avoid excessive delays.
   - Any delays in assessing claims due to their complexity should be agreed between the parties.

- Any claim that is not assessed within a reasonable period of time after an internal complaint is lodged should be assessed in line with ASIC Regulatory Guide 165.

10. That an enforceable code(s) as described above would be preferable to a legislated solution.

11. That the Royal Commission look to effectively disincentivise delay in life insurance claim assessment, through applying scrutiny to claim delay and withdrawal rates with regard to the 'penalty interest verses investment return' conflict.

12. That the Royal Commission recommend extending Unfair Contracts Terms laws to cover general and life insurance contracts.

The provision of a compensation scheme of last resort safety net for consumers

The Issue:

There is a need for a right of direct recourse by consumers against the Professional Indemnity (PI) insurers of Financial Service Providers (FSPs). There is a lack of consistency in the rules upholding this right across jurisdictions, and attempts to access information about a wrongdoer's insurance provider are often stymied by the existing regulations. A Compensation Scheme of Last Resort (CSLR) is required to ensure justice for consumers, regardless of the financial status of the wrongdoer.

The Historical Context:

The Global Financial Crisis (GFC) bought into sharp focus that many people had coupled their future financial stability to assumptions of continued growth, and the stability of investments. Maurice Blackburn is confident that the Royal Commission will hear many harrowing personal stories of how this coupling was based on poor advice given by FSPs, and that this advice was provided to the benefit of the FSP, and not in the best interest of the consumer.

Imprudent financial service operators (such as Wealthsure and Storm Financial) became prolific, and their downfall during the GFC was dramatic and well publicised.

Consumers found that achieving recourse through External Dispute Resolution (EDR) processes was complex and often futile due to the FSP being insolvent and the EDR scheme being unwilling or unable to enforce or in some instances to even make a determination against the FSC or its PI insurer.

The Current Situation:

In pursuing a FSP which is in liquidation, it can be very difficult and costly to identify who its PI insurer is (or was at the relevant time) as the liquidator typically will not disclose this information on confidentiality grounds. Neither ASIC nor the EDR schemes currently allow for, or require, this disclosure. Indeed, ASIC does not approve PI insurance arrangements for FSPs and does not have data about the renewal of advice licensees' PI insurance cover.

Current EDR processes such as the Financial Ombudsman Service (FOS) and the Credit & Investment Ombudsman (CIO) only accept disputes against FSPs that are registered members. When an FSP loses its AFS licence or no longer provides financial services, its membership ceases. FOS has had a practice of processing at least some cases to determination even where the FSP has declared insolvency *after* the dispute has commenced, resulting in millions of dollars of unpaid determinations [26].

However, Maurice Blackburn is aware of circumstances where the CIO has declined to process matters to conclusion because the FSP has flagged its insolvency after the CIO dispute was lodged but before resolution.

Maurice Blackburn believes that the establishment of a CSLR should be a high order recommendation of the Royal Commission. Such a scheme should be accompanied by a nationally consistent framework for:

[26] *https://www.fos.org.au/the-circular-special-issue-april-2014/fos-forum/unpaid-determinations/*

- The monitoring and enforcement of adequate PI insurance arrangements by AFS licensees as part of their licencing requirements; and
- Public transparency of such arrangements including the name of the PI insurer and liability limit; and
- direct recourse by consumers against the tortfeasor's PI insurer through the newly established Australian Financial Complaints Authority (AFCA).

These initiatives are consistent with the practical doctrine of 'direct recourse' reflected in the comments of the Australian Law Reform Commission (ALRC) Report No.20[27] that:

> *"The fact that an insurer under a third party liability policy usually takes over the conduct of a claim by a third party against the insured might suggest that a third party should be entitled to bring a claim directly against an insurer in all cases."*

Indeed, there has been no serious argument made that third parties should not have a right of direct recourse so long as the insurer's rights to defend the action, as if it had been brought against the insured in the normal manner, are preserved. That is, giving the insurer the same rights and liabilities as if the action were against the insured[28] and providing that the insurer's liability is no greater than its liability to the insured[29].

The Human Face:

Since the GFC, Maurice Blackburn has worked on a daily basis with consumers, usually mum and dad investors, who have been hit hard by regulatory and market failures resulting in personal and financial distress for them and their wider family. One such example appears below:

> *Our clients met a Financial Adviser in 2001, who was licensed by Wealthsure Pty Ltd through playing on the same indoor soccer team. The Adviser approached our clients in 2003 spruiking his financial advice services. He told our clients that his investment strategy would allow them to pay off their mortgage faster and retire by age 55, by better utilising their mortgage payments.*
>
> *At that time, our clients' circumstances included that they were in their thirties and their combined income was $70,000. They had superannuation accounts with UniSuper and Portfolio Service Retirement Fund with balances of less than $111,000 and $10,000 respectively. They owned a home worth around $160,000 and had a mortgage of $85,000.*
>
> *After initially advising our clients to take out a margin loan of $51,000 with Colonial (although neither understood at the time the implications of a margin loan), over the next five years the Adviser advised them to undertake various high risk transactions, which included:*
>
> - *increasing the margin loan to $151,000 (with a Loan-to-Value Ratio of 80% based on the valuation of their home at that time);*
> - *borrowing further funds through investment loans including over $300,000 with Macquarie Bank to fund the purchase of units in various speculative managed funds including the Macquarie HFA Accelerator Plus HFA Fund, Macquarie*

[27] *http://www.austlii.edu.au/au/other/lawreform/ALRC/1982/20.pdf?stem=0&synonyms=0&query=law%20reform%20insurance%20contracts (p.210).*
[28] *Andjelkovic v AFG Insurances Ltd (1980) 47 FLR 348 at 355-6.*
[29] *Section 51(1)* Insurance *Contracts Act 1984; Gorczynski v Wandft Osmo Pty Ltd [2010] NSWCA 163 at [82], [83].*

> *Winton Global Opportunities Fund, Macquarie Alps 3, Great Southern Beef Cattle Project, Macquarie MQ gateway, Macquarie Atlas 5, as well as other share funds.*

The Adviser also recommended that our clients purchase insurances for which he would obtain a commission, even though they already had generous death and disability benefits through their existing superannuation fund memberships.

In 2007, the Adviser facilitated the refinancing of our client's home, which was then valued $350,000.

However the GFC seriously impacted upon their investments, which dropped in value significantly and over the ensuing years they would be subject to margin calls on numerous occasions. By late 2009 their investment assets were worth only $385,310 while they had debts of $680,258 – a loss of $294,948.

On 23 May 2014, Maurice Blackburn lodged a dispute on our clients' behalf with the Credit & Investments Ombudsman (CIO). By mid-2015, Wealthsure were still not ready to participate in a conciliation conference. On 22 September 2015, we were informed by the Administrator that Wealthsure had gone into Administration.

We participated in the creditor process on behalf of a number of clients affected by allegedly negligent advice from Wealthsure. We lodged proofs of debt however, because none had yet obtained judgment or received a determination from CIO or another alternative dispute scheme, all only had contingent debts.

It was clear from what was disclosed through that process that Wealthsure had insufficient assets to even meet proven debts, and its professional indemnity insurance had been exhausted after a judgment issued against it, on the back of what were likely many claims before that time through CIO and Court.

On 15 December 2015 we were informed by CIO that under their terms of reference they were able to discontinue a matter where a financial services provider had ceased trading, but they needed to consider the interests of the consumers. They had decided it was not in our clients' interests to continue the dispute to a determination (despite us asking them to do so, so that our clients' status as creditors was proven) because there were no prospect of them recovering their money.

Aside from being a compelling example of financial advice misconduct resulting in financial ruin for a trusting customer, this case study highlights how CIO did not have due regard for the interest of the consumer by refusing to determine his complaint (as it appears FOS is in the practice of doing). He may have been able to use that determination to make a claim under any future CSLR, to advance his claim with the liquidator or the PI insurer, or to pursue any phoenix entity.

Our Submission:

With specific reference to Term of Reference 1(f), (g) and (h), Maurice Blackburn submits:

1. That there is a need for a right of direct recourse by consumers against an insolvent tortfeasor's PI insurer through the newly established Australian Financial Complaints Authority (AFCA). This would substantially reduce the costs burden on the CSLR.

2. That the Royal Commission refer to the newly introduced *Civil Liability (Third Party Claims Against Insurers) Act 2017* (NSW) section 4, which reads:

   "If an insured person has an insured liability to a person (the claimant), the claimant may, subject to this Act, recover the amount of the insured liability from the insurer in proceedings before a court."

   We submit that these laws represent the benchmark for facilitating a fair and effective direct recourse regime.

3. That legislation such as the above differs greatly between jurisdictions, and warns that this may lead to 'forum shopping' amongst consumers seeking justice and recourse.

4. That, as a condition of licencing, FSPs' PI insurers should be registered and contractually bound by EDR decisions in relation to which the PI insurer is on risk.

5. That AFCA should be required to maintain a register detailing the insurance providers and amounts of cover of all registered FSPs.

6. That, at the very least, all EDR schemes should include the name and details of the relevant past and current PI insurers in their registers of FSP Members.

7. That AFCA be obliged to re-open complaints lodged with CIO (and FOS if applicable) from 2008 which CIO declined to determine on the basis that the FSP had ceased trading (as in the case study cited above) to allow a consumer to obtain a determination for submission to the CSLR.

In relation to the establishment of a Compensation Scheme of Last Resort, Maurice Blackburn submits:

1. That a scheme be established.

2. That all claims that would come within the jurisdiction of an ASIC approved EDR scheme (including AFCA) should be prima facie eligible for consideration under a CSLR. This would typically include claims for breach of contract, negligence and statutory breach against a provider of financial services. It would also include unsuitable loans under the Credit Law, and unjust contracts under the *National Consumer Credit Protection Act* (2009) (NCCP Act) in respect to which FOS and CIO currently have jurisdiction.

3. That it is reasonable to expect that consumers, in attempting to access a CSLR must:

   - Have proof of an attempt to take a dispute to EDR which was unsuccessful because the FSP is not a Member, or
   - Have proof in the form of a determination from a Court, Tribunal or EDR scheme in the consumer's favour.

The lodgement of a Proof of Debt with a liquidator should also be considered as a pre-requisite, particularly where the FSP is no longer a Member of an EDR scheme or cannot be sued without special leave.

4. That a CSLR should include rights to recover the full financial impact, although the capacity of the firm to pay could be an issue. We believe that the ability to pursue the directors of such firms would prevent phoenix behaviour occurring.

In the same spirit as our recommendations in relation to industry codes of practice, Maurice Blackburn does not believe that a CSLR should be industry administered – rather it should be subject to appropriate regulatory oversight.

The need for regulatory reform in the mortgage lending market.

The Issue:

Urgent reform of the *National Consumer Credit Protections Act* (2009) and Bankruptcy laws is required, to take a victim focused approach to rectifying the effects of poor lending practices.

The Historical Context:

A decade of soaring property growth, generous tax incentives for property investors and record low interest rates has resulted in Australians being among the most indebted households in the world.

A recent Australian Bureau of Statistics (ABS) report into household debt found that in 2015-16, 29% of households were classified as 'over-indebted', defined as having debt three times or more than disposable income, or debt equal to 75% or more of the value of assets. The average home loans for over-indebted households were over four times the size of home loans held by other households carrying debt ($286,400 compared to $59,500)[30].

Property growth can no longer be presumed, with the surging Sydney market beginning to plateau and even dip, while interest rates can only increase. Many would-be real estate entrepreneurs are starting to feel the strain of so much debt and distress sales are on the rise[31].

A combination of banks' relaxed lending standards and brokers' involvement in loan sales has resulted in widespread debt over-commitment that threatens the stability of the broader economy: A survey of more than 900 home loans conducted by investment bank UBS [32] found that around $500 billion worth of outstanding home loans are based on incorrect statements about incomes, assets, existing debts and/or expenses.

This means 18% of all outstanding Australian credit is based on inaccurate information, often caused by poor advice or misrepresentations by a mortgage broker eager to generate a sale commission. A staggering 30% of loans surveyed had been issued based on understated living costs and around 15% on understated other debts or overstated income.

Our experience in working with clients who are facing difficulty servicing mortgage debt indicates that, until recently, this problem has been contained. Investors who defaulted on their mortgages were often fortunate enough to sell the investment property at a gain or at least break even, clearing the mortgage without too much pain.

However it has been reported that if interest rates rise by 1%, more than 40% of homes would be in mortgage stress (for context, a 4% increase above current rates would bring

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[30] http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/by%20Subject/6523.0~2015-16~Feature%20Article~Household%20Debt%20and%20Over-indebtedness%20(Feature%20Article)~101

[31] *See for example* http://www.afr.com/personal-fiSeenance/record-numbers-under-mortgage-stress-20170501-gvw2vt

[32] *Australian Banking Sector Update. UBS Evidence Lab - $500 billion in 'Liar Loans'? (September 2017):* https://webcache.googleusercontent.com/search?q=cache:PhkZ9vGUMU0J:https://thejollyswagmen.com/s/UBS-LIAR-LOANS.pdf+&cd=9&hl=en&ct=clnk&gl=au

interest rates roughly in line with the average over the past two decades)[33]. This will further drive up distress sales in a stagnant or contracting market and may leave thousands in financial ruin, staring at the prospect of bankruptcy.

Of particular concern is the prevalence of interest-only loans, or loans with an interest-only period. A large proportion of mortgage loans issued over the past decade have an interest-only component. These loans have an initial period, usually five years, where only the interest on the loan is repaid. However, after the interest only period expires, the loan repayments can increase by between 30 and 60% which can push the customer into mortgage stress.

A review of home loans with an interest-only period conducted by ASIC[34] found that:

- In 40% of applications, the affordability calculations assumed the customer had longer to repay the principal on the loan than they actually did;
- In over 30% of applications, there was no evidence that the lender had considered whether the interest-only home loan met the customer's requirements; and
- In 20% of applications, lenders had not considered the customer's actual living expenses when approving the loan, but relied instead on expense benchmarks.

It has also been reported that up to a third of borrowers with interest-only loans may not realise they have them[35].

Toward the end of 2017, Westpac was forced to provide 13,000 owner-occupiers who have interest-only home loans with a total of $11mil in refunds. According to ASIC[36]:

"*The remediation follows an error in Westpac's systems which meant that these interest-only home loans were not automatically switched to principal and interest repayments at the end of the contracted interest-only period*."

These examples of lender behaviour help to explain the apparent lack of positive consumer sentiment, and the need for reform in the sector.

The Current Situation:

Maurice Blackburn draws the Royal Commission's attention to two current, yet easily remedied issues in the legislative framework. The first refers to the legislated timeframe to lodge a compensation order. The second refers to potential perverse outcomes in cases involving trustees in bankruptcy proceedings.

1. The legislation providing consumer recourse over poor lending practices currently makes it possible for a complainant to run out of time to achieve recourse, by the time they suffer the loss.

   Section 178 of the *National Consumer Credit Protections Act* (2009) deals with Compensation Orders – orders for compensation for loss or damages as a result of poor lending practices. Sub section (2) states that:

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[33] See for example http://www.abc.net.au/news/2017-08-21/how-interest-rate-rises-could-Seeaffect-home-loan-stress/8798274

[34] ASIC Report 445 – Review of interest-only home loans (August 2015), http://download.asic.gov.au/media/3329474/rep445-published-20-august-2015.pdf (p.9)

[35] See for example http://www.abc.net.au/news/2017-10-04/consumers-unaware-they-have-interest-only-home-loans/9014448

[36] http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-436mr-westpac-refunds-11-million-to-interest-only-customers/

The court may make the order only if:

(a) the plaintiff or ASIC (on behalf of the plaintiff) applies for an order under this section; and

(b) the application is made within 6 years of the day the cause of action that relates to the contravention or commission of the offence accrued.

This, in effect, allows for the situation where, by the time a potential plaintiff is aware of the losses he/she has suffered as a result of poor lending practices, the timeframe for lodging an order has already expired.

2. The legislation providing instruction in circumstances where a trustee is involved in the distribution of assets in a bankruptcy may enable perverse outcomes for those caught up in poor lending practices.

   If a victim of poor lending practice finds him/herself facing bankruptcy as a result of others' wrongdoing, the wrongdoer may be listed as a creditor in the proceedings. This places the trustee in an invidious situation:

   - Section 19 of the *Bankruptcy Act* (1966) sets out the duties of a trustee.
   - In providing advice on the interpretation of these legislated duties, the Inspector-General Practice Direction[37] notes that a trustee must fulfil a fiduciary duty – the duty to use care and skill, and the duty to act in good faith (section 4.2)
   - The Inspector-General, in the same document, provides an analysis of case law relating to this duty, and cites Justice Spender in *Doolan v Dare* as follows: *'It is clear that the trustee has an obligation to administer the estate in the interests of the creditors and the bankrupt*.' (section 4.22)

   In the circumstance of a borrower forced into bankruptcy due to debt over commitment that would give rise to a claim of irresponsible or unjust lending under the NCCP and *National Credit Code*, their cause of action would vest the trustee in bankruptcy pursuant to section 116 of the *Bankruptcy Act* (1966). However, according to the above, the trustee in bankruptcy may owe a duty of care to the irresponsible lender as a creditor. This means that the irresponsible lender may have an interest in the cause or action against itself, which it may use to influence the determinations of the trustee in bankruptcy including whether the cause of action should be pursued or assigned.

   We believe it is essential to rectify this perverse outcome.

   One way to remedy this is to legislate an exception in section 116(2) *Bankruptcy Act* (1966) such that actions taken under the *National Consumer Credit Protections Act* (2009) and National Credit Code are not divisible among creditors. That is, causes of action against any creditor should be quarantined under bankruptcy law.

[37] *https://www.afsa.gov.au/about-us/practices/inspector-general-practice-directions/inspector-general-practice-direction-14*

The Human Face:

In 2011 or 2012 Adam and his partner Wendy purchased two off the plan units through a company called Investor Property (IP).[38] The units were valued at approx. $442,000 and $446,000. IP told him that current rental yields were $1,200 but may drop to $800 since they were likely at their peak. IP also warned there probably wouldn't be much capital growth but they would provide cash flow.

IP also acted as the mortgage broker and the initial advice from Westpac was they would offer loans with a 90% LVR. The properties took twelve months to settle at which time Westpac said they would only lend with a 70% LVR.

At this time (2013) Adam was a teacher and his wife was resuming part-time work after looking after their four dependent children, the oldest being 12 years old. They also received Centrelink benefits (family tax benefit).

They owned their home with a mortgage with Westpac, not used as security for any of the investment loans. As Westpac would only loan 70%, IP facilitated vendor finance at $150,000 (9 or 10% interest) and they also pulled some equity out of their home.

They obtained three interest only loans with Westpac:

- *In 2013, $308,000 for a property valued according to Westpac at $461.6k*
- *In 2013, $308,000 for a property valued at $474k*
    - *Both of these were for a 30 year term with a 10 year interest only period. There was a two year period where a discounted interest rate applied (4.99% then 5.81%).*
- *In 2014, $42,000 to cover shortfall because even after vendor finance and using equity they still didn't have enough with Westpac only lending 70%.*
    - *This loan was for a 30 year term with a 5 year interest only period, at 4.98% interest*

It does not appear that Westpac independently verified Adam's and Wendy's income, which was said to be $85,490 gross. They believe their income was $6,645 per month, including the Centrelink benefit.

Westpac appear to have used the Household Expenditure Measure (HEM) benchmark to calculate living expenses, as there was no evidence of any enquiries as to their actual expenses. The loan documents say their 'absolute basic' expenses were $881 in 2013 and $1010 in 2014.

In fact, their expenses were $5,590 excluding their mortgage payments which for their home only were approx. $1,900. Their home was worth about $1.5mil at this time.

The units were rented out for $800 (furnished) and $700 (unfurnished) but after twelve months that dropped to $600 and then $400. They started experiencing difficulty when the price dropped to $600 as the rates and body corporate expenses were $14,000 per annum which was double what they expected.

[38] https://investorproperty.com.au/:

> *Westpac took possession of the properties last year and have appointed an agent to try to sell the properties. The properties are currently valued at about $200,000 each.*
>
> *Adam and Wendy have now entered into voluntary bankruptcy as 'they saw the writing on the wall' and knew Westpac would be recovering the shortfall from them.*
>
> *As a consequence, they no longer own their legal cause of action against Westpac for breaches of responsible lending laws.*

Our Submission:

In response to Terms of Reference 1(f)(i) and 1(h)(i), Maurice Blackburn recommends the following:

1. That section 178(2)(b) of the NCCP Act (2009) be amended to clarify that causes of action run from the date that the losses are realised in accordance with the principles espoused in *Wardley Australia Ltd v State of Western Australia* (1992) 175 CLR 514.
2. That section 116(2) of the *Bankruptcy Act* (1966) – the section which lists the exclusions from the property divisible among creditors – be expanded to include property which is subject to a cause of action under the NCCP Act against a creditor.