

advice.<sup>23</sup> Such a 'needs analysis' would indicate the appropriateness or otherwise of the superannuation product sold to the consumer.

**Recommendation 3.2:**

The Committee recommends that, in conjunction with investment information, a 'needs analysis' based on the consumer's individual circumstances and preferences should be carried out and retained by both the life office and the consumer as verification of advice to the consumer.

*Clarification of Industry Terminology*

3.30 The Committee's Issues Paper suggested that the introduction of standard terminology would assist consumers in making meaningful product comparisons as well as their understanding of the market. In the United Kingdom, the Securities Industries Board requires that certain standardised phrases be used in promotional documents. A similar approach to common terms used in the industry would benefit consumers.

3.31 Commenting on the standardisation of terminology, the ISC stated that it:

... acknowledges that while standardised nomenclature would be useful, it may be difficult to enforce on a legislative basis. In most areas of commerce the legislative requirements or titles are not often used by industry participants in their dealings with the public. Any introduction of standardised terminology might well lead to standardisation in communication between certain parties but not in the final interface between the company/intermediary and the consumer.<sup>24</sup>

3.32 The Committee notes that LIFA is currently developing proposals to simplify policy documentation and related material. These proposals should be evaluated by the ISC with a view to their introduction, where appropriate, throughout the industry.

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<sup>23</sup> RMRC, op cit, p 4.

<sup>24</sup> ISC, Response to the *Issues Paper*, p 13.

**Recommendation 3.3:**

The Committee recommends that the ISC encourage the adoption by the industry of standard clauses within promotional material and contract documentation and the adoption of plain English documentation.

In implementing this policy, appropriate material for consumers from a non-English speaking background should also be developed.

**Disclosure of Fees and Commissions**

3.33 The range of fees payable by members of occupational and industry superannuation funds depends on the extent to which services such as record keeping and administration, investment management and custodial services are contracted out or performed in-house. The market is highly competitive for the provision of these services and costs are thereby kept to a minimum. In addition disclosure of such fees is mandatory.

3.34 With regard to personal superannuation, that is contracts between individuals and providers (usually life insurance offices), a range of fees is imposed to recoup the commissions paid to agents and costs to the life office. These may take the form of establishment fees, annual fees, exit fees or a combination of these.

3.35 The question as to whether agents should disclose to potential customers the amounts and bases of commissions they receive has aroused sharp differences of opinion. The general rationale for disclosure is that it is necessary in order to ensure that the market is fully informed, a prerequisite for being fully competitive. There are, however, a number of more specific reasons for disclosure.

3.36 The traditional life insurance industry was dependent on a marketing system based on commission payments to agents, or 'consultants', who operated as independent businesses, some tied to one company, others independent. While there is only limited objective evidence available, the system lent itself to inefficiencies in establishment and operating costs. The most telling evidence is that which points to high rates of policy surrenders and low policy surrender values indicating substantial leakages from the

retirement income flow. Certainly, the time spent on unsuccessful one-to-one canvassing had to be paid for out of commissions on successful sales. As companies tried to build market share, they tended to increase benefits to agents, either through higher commissions or through other devices such as very low interest loans. One submitter informed the Committee that, in addition to renewal and asset based commissions, some agents received 'overwrite' commissions based on aggregate production which can be as high as 70% of the initial commission.<sup>25</sup>

3.37 The question the Committee asks is, where there is a standardised product type, why, in the context of a compulsory superannuation environment, which may be extended at some future juncture to include the entire workforce, including the self-employed, is it necessary for anyone to pay hundreds or even thousands of dollars for the privilege of taking out a superannuation policy? However, the Committee affirms that, consistent with any award or employment contracts, those members of the workforce who wish to purchase superannuation plans should still be free to choose a product of their choice, regardless of its front end commissions or other charges.

3.38 Commissions on regular premium superannuation products are sufficiently large as to be the dominant factor in the setting of exit fees or surrender values on discontinued contracts, particularly in the early years. As noted previously, this was the principal area of complaints to the Committee and, in some cases, over 90 per cent of the first two years' premiums were absorbed in this way. As more than half of all super policies are discontinued within six years, the scope for misunderstanding at best and deception at worst, is obvious. Increased levels of disclosure at the outset would, by allowing for comparison of advisory service costs, assist in minimising these problems.

3.39 Information presented to the TPC shows that more than two-thirds of purchases of superannuation products relied on oral information presented by the agents and about the same proportion knew the agents prior to the commencement of the discussions.<sup>26</sup> It is quite apparent, therefore, that personal factors, such as trust, friendship, integrity and the like, play a major

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<sup>25</sup> The joint submission of 5 March 1993 from the Australian Society of CPAs and the Institute of Chartered Accountants (Joint CPA submission), p 5.

<sup>26</sup> RMRC, *op cit.* pp 3-5.

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part in clients' attitudes to agents. This being so, a reminder that the agent is the representative of, and is legally accountable to, the company rather than the client would be appropriate. Recommendation 3.6 addresses this matter.

3.40 Both the companies and the agents have supported the existing system on the grounds that the agent performs a valuable task in the provision of financial advice, geared to long-term planning. It was submitted that this is a highly skilled function and one worthy of adequate reward.<sup>27</sup> If this is the case, then the adviser has a duty to inform the client of the 'fee' payable for the advice, just as the client has a right to know the charges. The client would then be in a position to compare the advice, and its cost, with that available from professional investment advisers operating on a fee-for-service, rather than a commission, basis. In any event, the argument falls down completely since the commission is paid on the sale value, rather than the time spent.

3.41 Finally, full disclosure of commissions would inhibit, if not completely eliminate, the practice of 'twisting', that is advising the client to surrender a policy in order to take up a new one, thereby earning the agent a new commission. It would also assist customers to make a rational choice when a number of different products are offered by the same company. At present, there is a strong temptation for agents to promote those products which earn the largest commissions. This practice is referred to in industry jargon as 'commission bias'.

#### *The TPC Inquiry*

3.42 The TPC inquiry recommended that all insurance intermediaries should be required to disclose the amounts of commission and other benefits payable by the supplier as a result of the sale of superannuation products. In arguing this case the TPC also pointed to 'commission bias', whereby the level of commission influences the type of product recommended by the agent. The Committee agrees that the level of commission has the potential to influence the marketing strategy employed by some agents and that a greater openness by agents, and an expectation on the part of consumers to be made aware of all relevant costs associated with the sale of superannuation plans, would virtually eliminate this bias.

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<sup>27</sup> LIFA, sub no 114, p 27; Australian Lifewriters Association, sub no 49, p 2 and submission to TPC, pp 3-4.

3.43 In conducting its inquiry, the TPC commissioned a number of consumer surveys and a series of analytical studies, one of which was conducted by the investment adviser, Mr Daryl Dixon. Mr Dixon's research made conclusions about the quality of decisions for a sample of recent purchasers. He found that on a five point ranking scale ranging from 'excellent' to 'very poor' that 81 per cent of recent purchasers made average or better decisions while 18 per cent made poor or very poor decisions.

3.44 The TPC compared Mr Dixon's ratings with the information provided to customer data (see table 3.4) and concluded that:

there appeared to be a strong relationship between the quality of the purchase decision and being 'told' about commission arrangements. Those who were told about commission arrangements made an 'excellent' decision three times more often than those who recorded 'didn't mention'<sup>28</sup>

#### *Australian Law Reform Commission Report No 59*

3.45 The Australian Law Reform Commission (ALRC) report No. 59 on *Collective Investments: Superannuation* concluded that disclosure of commissions 'will assist people to be aware when buying a policy of any sort, what the benefit is to the seller'. The ALRC therefore recommended that life agents selling superannuation should be subject to the same disclosure requirements as the Corporations Law which provides for disclosure to the client by the adviser of any interest which may be capable of influencing a recommendation, and of any benefit which may flow to the adviser from the recommendation.<sup>29</sup>

#### *Definitions of 'Commission' and 'Disclosure'*

3.46 The view that commissions should be disclosed was generally supported by consumer groups. It was suggested that the disclosure of commissions would help consumers make rational and informed choices as to the appropriate product for their individual circumstances. For example, the ACA recommended disclosure of commissions at both pre-contractual

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<sup>28</sup> Op cit, Trade Practices Commission, p 98.

<sup>29</sup> ALRC, *Collective Investments: Superannuation*, 1992, p 8.

and contractual stages.<sup>30</sup> It was also suggested that disclosure would allow comparisons between different products and with other products of a similar type.

3.47 LIFA stated that greater disclosure of fees and charges 'would assist potential superannuation fund members make as informed decision as possible'.<sup>31</sup> During the inquiry LIFA further contended that it:

does not believe that a potential policy holder or superannuation fund member needs to know what the agent or sales person receives by way of remuneration in order to make an informed decision.<sup>32</sup>

3.48 A difficulty with commission disclosure is in its definition as commissions paid to agents can take many forms. For example, LIFA stated:

does it [commission disclosure], for instance, include non-cash remuneration, which is not uncommon in many industries including the life insurance industry. If, for disclosure purposes, commission was defined in purely cash terms, the potential for avoiding disclosure by remunerating agents with non-cash benefits is patently obvious. Even where an agent's remuneration is in cash, this often takes many different forms such as retainer plus commission, office allowance etc.<sup>33</sup>

A further difficulty is the complexity in calculating commissions for products other than single premium policies.

3.49 These problems can be directly addressed by the inclusion in legislation of a definition of 'commission' sufficiently broad so as to encompass these variations and establish the relationship between companies and agents. For this initiative to be successful, it is essential that the ISC and the industry liaise and strike an appropriate outcome.

3.50 The *Issues Paper* noted that current guidelines require disclosure of fees and charges for some life products. The requirements provide that regular premium products must state the effect of all charges, including

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<sup>30</sup> ACA, sub no 227, para 4.1.

<sup>31</sup> Sub no 114, p 31.

<sup>32</sup> *ibid*, p 32.

<sup>33</sup> *ibid*

commissions, on policy benefits<sup>34</sup>. However the ISC guidelines do not require commissions to be identified separately.<sup>35</sup> In responding to the Issues Paper, the ISC reaffirmed its policy that regular premium products must state the effect of all charges including commission. The ISC further submitted that it was examining the issue of commission disclosure and that it was participating in the TPC inquiry.<sup>36</sup>

3.51 The position of LIFA, whilst it is under review, is that 'all fees and charges will be disclosed, as well as the effect thereof on benefits'.<sup>37</sup> The Committee believes that, whilst this regime is a sound one in respect of giving consumers information about the products being sold, it falls short of allowing them to make independent and informed judgements about the motives of the agent selling the product and the cost of the financial advice prior to sale. The latter point is one which the Office of Fair Trading (UK) also holds. It believes that commission disclosure, or 'price transparency', will enhance competition on price and quality amongst financial advisers.<sup>38</sup>

3.52 In view of the unequal bargaining regime between life offices and consumers as illustrated in the case studies in Chapter 2 and analysed in paragraphs 3.33 to 3.51 the Committee believes that additional disclosure is necessary.

#### Recommendation 3.4:

The Committee recommends that life insurance agents disclose both orally and in writing the amounts of commission, as well as other benefits that accrue to them, as a consequence of the sale of personal and group superannuation products.

<sup>34</sup> ISC Circular 276

<sup>35</sup> Sub no 151, p 35.

<sup>36</sup> Submission No 151, Additional material of 17 November 1992, p 17.

<sup>37</sup> See Appendix F, p 84.

<sup>38</sup> Op cit, London Economics, p 1.

3.53 But any moves towards increased disclosure should only be made after appropriate consultation between the industry and the regulator, the ISC. The regime which is promulgated should not place insurance agents in a position whereby they are the only party in the superannuation industry with a duty to disclose the cost of their services. In this regard all providers of superannuation products will also need to disclose costs which materially affect the price and returns of the product and/or the way in which it is marketed.

3.54 The Committee believes that the fluidity of the superannuation industry is such that new product types will be developed with a view to avoiding this new commission disclosure regime. The role of the industry watchdog, the ISC, will be critical in ensuring that new growth products reflect both the spirit and the letter of the new requirements thereby ensuring that high standards of consumer welfare are upheld.

3.55 Any new and more detailed disclosure regime should be regularly reviewed by the ISC and reported to the Parliament for examination by an appropriate parliamentary committee.

**Recommendation 3.5:**

The Committee recommends that any new commission disclosure scheme applying to life insurance agents be reviewed by an appropriate Senate Committee within three years.

3.56 The Committee stresses that, whilst, commission disclosure by agents and other parties is an important issue, it is not the only issue and it has at times distracted attention from more fundamental considerations of critical long term importance.

### **Disclosure Standards Consistent With Agency Relationship and Statement of Relationship**

3.57 In its submission to the Committee, the Attorney General's Department stated that:



Consumers often complain that subsequently they discover that they have been sold products which are inappropriate to their circumstances because the sales person was either swayed by influences such as commissions rather than their needs or lacked the professional skills to provide adequate advice.<sup>39</sup>

3.58 Similarly the ACA stated that it was very hard for consumers to assess the independence and appropriateness of the 'advice' they receive which meant that they 'are very susceptible to exploitation and that the role of the intermediary is critical'.<sup>40</sup> Because existing guidelines do not require disclosure of the nature of the agency relationship, consumers can be confused as to the status of agents when they are described as 'independent' advisers.

3.59 In the Australian market place, there are four types of agency relationships: sole agent, first option, multi-agent and life broker. It should be noted that current guidelines do not require the agent to provide information regarding the type of agency relationship he or she has with the life office. However, as was pointed out by the Attorney General's Department<sup>41</sup> and Mr Michael Petch<sup>42</sup> the non disclosure of a commission by an agent selling superannuation products to a principal (client) would be an offence under the secrets commission provisions of the criminal codes in the States and Territories.

3.60 The Attorney General's Department submission took care to point out that these provisions do not apply to situations where the person receiving a commission is the agent only of the provider of the superannuation package. These provisions do not, therefore, comprehensively cover the disclosure of fees, charges and commissions, as the greater majority of personal superannuation sales involve agents who have life office principals.<sup>43</sup>

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<sup>39</sup> Sub no 107, p 32.

<sup>40</sup> Sub no 227, Attachment, p 5.

<sup>41</sup> Submission no 107, Supplementary material of 19 August 1992.

<sup>42</sup> Submission no 228.

<sup>43</sup> Op cit, Attorney General's submission, p2.

### *Sole Agents*

3.61 Typically a sole agent represents only one life office. Although the sole agency agreement requires the agent not to hold an agency with any other life office, the agent may offer products sourced from the parent company or its subsidiaries or other approved companies. The Trade Practices Commission estimates that 50% to 60% of regular premium insurance is distributed through the agency system.

### *First Option Agents*

3.62 First option agencies allow the agent to offer products from other companies at the agent's discretion but there is usually a requirement that they not offer other products which compete with those of their principal life office.

### *Multi-Agents*

3.63 Multi-agents have agency agreements with several life offices. The advantage of the multi-agent arrangement for the agent is that it allows the agent to select from products offered by a wider range of companies. The number of multi-agents grew rapidly in the 1980's mainly as a result of decisions of some of the smaller life offices to move away from the sole agency approach to marketing.

### *Life Brokers*

3.64 The majority of life brokers operate in the corporate market where they arrange group life and managed funds for corporate superannuation schemes. They play only a small role in the regular premium superannuation market. Life brokers charge a fee for advice provided.

### *Towards Increased Disclosure of Agent-Principal Relationships*

3.65 The Committee agrees with the ACA that agents should disclose their agency relationship at the outset 'as either a sales representative or an independent adviser and which company [or companies] they represent as required in the UK.'<sup>44</sup>

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<sup>44</sup> Sub no 227, para 7.7.

3.66 These disclosure requirements will ensure that consumers are aware of the agents' status and relationship with life offices. The statement of agency relationship should be included at the beginning of the 'needs analysis' to verify that the consumer was informed as to the particular agency arrangement.

3.67 This approach flows from the concept of 'polarisation' of the type of agent providing the advice. The *Issues Paper* suggested that to ensure that agents or advisers provide impartial, objective financial advice it would be necessary for agents to identify clearly whether they are 'tied' to a life insurance company/office or are independent agents. The concept of the polarisation of agents already operates in the United Kingdom.<sup>45</sup>

**Recommendation 3.6:**

The Committee recommends that, to distinguish the role of the different types of agents and life brokers, agents should be required to disclose:

- the organisations with which the agent holds agency agreements;
- whether the agent is acting for the life office(s) with which the agent holds agency agreements and the nature of the fiduciary relationship with the life office;
- whether the agent is remunerated in whole or in part by commission on behalf of the life offices for selling the companies' life products;
- whether the commission will be paid from charges imposed by the policy; and
- the manner in which early surrender charges will be calculated.

<sup>45</sup> G. Moon, sub no 123, p 21.