

Insurance is not a special case

Claire Mackay and Tim Mackay outline why risk products should not be carved out of the Government's plan to ban product commissions

We do not understand why the proposed ban on commissions by both the FPA and the Federal Government does not also cover life risk products. In our family-owned business, we have successfully implemented a transparent, fixed-fee approach, which our clients support and which encompasses all financial products.

Arguments by the industry that insurance commissions are a "special case" appear to consumers to be self-serving, and ultimately undermine the professionalism and credibility of our industry.

The main reasons we hear in support of commissions are that a ban would be to consumers' detriment, would lead to higher premiums and would exacerbate underinsurance.

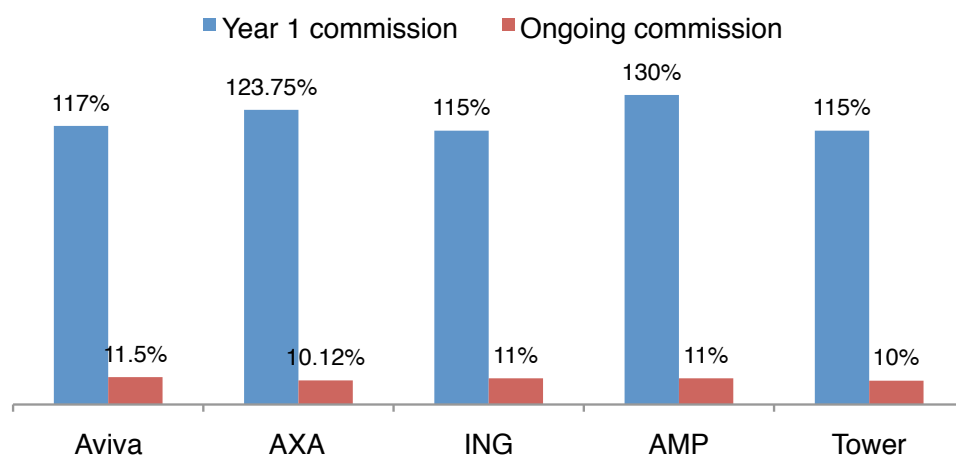
All consumer advocacy groups that we have spoken to, including Choice, support a commission ban across all financial products. Choice describes all commissions as "perverse incentives" and lobbies to have them banned. So despite arguments put forward by industry, consumers themselves do not believe banning commissions would be to their detriment.

We have not seen logical arguments or empirical evidence that demonstrate a commission ban would result in higher premiums in the long term.

The only credible short-term reason for higher premiums for risk products is due to a potential exodus of commission-based advisers who may be fearful and unwilling to implement the reforms, which will reduce the number of advisers in the short term.

However, we believe it is in consumers' interests to have fewer professional advisers who they trust rather than having more advisers operating under the broken commission model in which consumers no longer have any faith. In the medium to long term, we believe a commission ban

Chart 1: Upfront and ongoing commissions



will lead to increased, transparent competition resulting in a reduction in fees for consumers.

Currently the cost of commissions is hidden, wrapped up in the premium paid. Defenders of commissions argue disclosure is adequate. According to a former High Court Chief Justice, Sir Anthony Mason, when it comes to current financial product sales practices, "Detailed and dense disclosure is often the most effective form of concealment".

Those who defend commissions are effectively arguing that it is OK to continue to hide the cost from consumers. To us, this seems like an appalling argument supporting commissions. According to Ric Battellino, deputy governor of the Reserve Bank of Australia: "This reluctance to pay for advice upfront appears to be a form of money illusion, whereby investors may feel that they are somehow paying less for financial advice if the cost is buried."

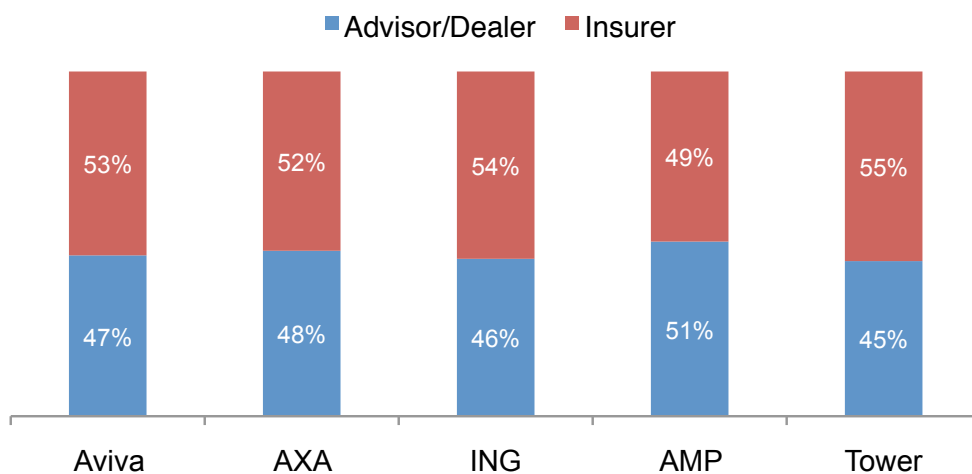
We believe a ban on all commissions empowers consumers with a clear and transparent understanding of how much they are paying, to

whom, when, and for what.

We believe that commissions reduce competition and drive up premiums. While the insurance industry is competitive, we argue that competition is at the wrong points in the value chain. Rather than competing on premium price, insurers compete on the level of upfront commission they dangle in front of advisers. We show the upfront and ongoing life commissions offered in Chart 1.

For example, if a couple was advised into AMP policies with premiums of \$4000 in the first year, their adviser could receive \$5200 in commission up front (130 per cent from AMP) and \$440 (11 per cent from AMP) in following years. Insurers offer advisers subsidised upfront commissions larger than the premium paid as a sweetener to woo their business. We understand why advisers prefer commissions to remain embedded in the premiums - if commissions were banned advisers would struggle to justify to their clients charging such relatively large payments up front.

Chart 2: Share of premiums paid



If these policies were held by the couple for three years, we estimate the adviser and their dealer group will receive between 45 per cent and 51 per cent of the total cumulative premiums paid by the client. (This decreases to a 31 per cent to 35 per cent adviser/dealer share if the policies are held for five years.)

So the client pays the premium and then the insurer, the dealer and adviser all fight over that pie. It is in no-one's interest to make that pie smaller but it is in everyone's interests to negotiate a bigger slice of that pie. Therefore, competition exists at the insurer/dealer/adviser level, but less so at the client level.

Now, if we turn this on its head and remove commissions, the adviser must now negotiate advice fees with the client every year. The adviser will have to demonstrate to the client that their advice is value adding and they now will be in effective competition with the insurer for a certain slice of the client's wallet.

We often hear "underinsurance" provided as a defence for life insurance commissions. However, the "underinsurance" problem has arisen entirely under the existing commission-based system. Therefore, to use underinsurance as a key reason to support the continuation of commissions, to us appears nonsensical.

We believe banning commissions could actually help address underinsurance. From Chart 2 it is clear that advisers who receive upfront

commissions share 45 per cent to 51 per cent of total cumulative premiums. If commissions were banned and the savings were entirely passed onto consumers in the form of reduced premiums, this could result in premiums immediately falling by between 45 per cent and 51 per cent in price.

Price is the key determinant of demand, not the aggressive selling techniques or remuneration structure of the sales force. Significantly decreased prices would lead to significantly increased demand. A ban on commissions could be an effective way for the Government to help address the underinsurance problem.

The FPA's position in its 2009 Remuneration Policy is that commissions on all financial products result in a real or perceived conflict of interest between the adviser and the client. Consumers demand and rightly deserve life risk advice that is free from real or perceived conflict of interest. Our industry deserves a single remuneration regime that helps drive increased professionalism. Life risk products should not be an exception and any real (or perceived) conflict from ongoing commissions can only be to the detriment of consumers.

We believe that having multiple charging regimes will be complex and confusing for consumers. We know from 2012 there will be two charging regimes for financial products - the new rules banning commissions will apply to new investment products issued from 2012 and

the old rules allowing commissions will apply to existing investment products.

If life insurance commissions are also excluded from the ban, consumers and holistic financial planners will need to operate under three different sets of rules - one for old investment products, one for new investment products and one for existing and new life insurance products.

From a consumer perspective, let's assume they pay a fee for investment advice and receive advice on life risk products at the same time. After 2012, the consumer may believe that advice for both types of product are included in the fee. If they understand that the adviser is remunerated separately by the provider for the life product, this may lead to confusion and it may alter their perception of the value of the fee.

There are obvious significant benefits to consumers and advisers in having one, easily understood, uniform remuneration system that applies uniformly and consistently across all financial products.

If there is a commission ban on investment products and not life risk products from 2012, advisers providing holistic advice could have a real (or perceived) incentive to focus more on life risk products (where they can get paid up to 130 per cent of the premiums upfront) at the expense of investment products (which do not attract commissions).

Sadly, this type of situation could compromise the industry's drive for professionalism and cause consumers to question the adviser's real or perceived balance and suitability of advice. ■

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