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Market Bulletin

Ref: Y5305

Title	New design and distribution obligations and unfair contract term changes in Australia
Purpose	To outline the impact that the new design and product distribution obligations and unfair contract term changes will have on Lloyd's insurance arrangements in Australia
Type	Event
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Date	1 September 2020
Deadline	5 April 2021 for unfair contract terms provisions 5 October 2021 for design and distribution obligations
Related links	Treasury Laws Amendment (Design Distribution Obligations and Product Intervention Powers) Act 2019 (N.50, 2019) Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Act 2020 Australian Securities and Investments Commission Act 2001

New design and distribution obligations and unfair contract term changes

This communication outlines the impact of the following regulatory developments:

(1) Design and distribution obligations (DDO) for retail general insurance business, introduced into the Corporations Act 2001 (Cth); and

(2) Unfair contract terms (UCT) provisions for certain insurance contracts caught by the Insurance Contracts Act 1984 (Cth), introduced into the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act).

Please note that marine insurance business in scope of the Marine Insurance Act 1909 is already subject to the unfair contracts regime currently in force under the ASIC Act. This communication addresses general insurance only.

Underwriters (including managing agents) and coverholders are affected by the DDO and UCT obligations, which are due to come into effect on 5 October 2021 and 5 April 2021 respectively. We recommend that managing agents and coverholders monitor any impact that the COVID-19 crisis has on the implementation of the regimes.

While the two regimes do not impact an identical suite of products, all DDO type products should undergo a UCT review as part of the DDO suitability review process, even where they are not in scope of UCT requirements.

This will also help ensure other requirements such as compliance with the Insurance Contracts Act 1984 (e.g. duty of utmost good faith), general obligations under the Australian Financial Services Licences held by coverholders (e.g. duty to act efficiently, honestly and fairly) and The General Insurance Code of Practice are also properly addressed.

We also recommend that managing agents and coverholders seek legal advice on how the DDO and UCT provisions apply to business written in Australia.

Design and Distribution Obligations (DDO) regime

The DDO regime introduces principles-based design and distribution obligations to retail insurance business. The obligations are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to designing and distributing products. The obligations do not equate to an individual product suitability test that would require assessment based on an individual's personal circumstances at point-of-sale.

The regime will apply to general insurance contracts for products issued to retail clients that are new, renewed or varied from 5 October 2021. 'Retail client' is defined in s761G(5)(b) of the Corporations Act and the Corporations Regulations 2001.

The DDO obligations are generally linked to retail product distribution conduct, which includes:

- dealing in insurance e.g., issuing new business, renewals and mid-term variations to include new type of retail cover;
- applying for or acquiring a financial product;
- arranging for a person to engage in either type of conduct;
- the obligation in Part 7.9 of the Corporations Act 2001 to give a Product Disclosure Statement;
- providing financial product advice (see s944A of the Corporations Act 2001 definition for full details).

DDO obligations applicable to insurers (i.e. underwriters as represented by their managing agent)

The key obligations of an insurer are to:

- Make a written target market determination (TMD) that meets certain content requirements;
- Make the TMD available to the public free of charge;
- Ensure the TMD is appropriate;
- Review the TMD;
- Where a review trigger has occurred or the TMD may no longer be appropriate, cease distribution until it is;
- Take steps regarding regulated persons acting consistently with the TMD;
- Collect and keep records of certain information;
- Keep accurate records of decisions relating to a product's TMDs, review triggers, review period and reasons for those decisions;
- Notify the Australian Securities & Investments Commission (ASIC) of significant dealings that are not consistent with TMD; and
- Update advertising in relation to a TMD product subject to s1018A of the Corporations Act 2001 to include extra information.

The full list of DDO obligations applicable to insurers is set out in Appendix 1.

Underwriters (through their managing agents) will need to identify if the coverholder or others will help underwriters meet any of these insurer obligations and if so, on what terms. While an insurer can delegate such tasks, it is responsible under the law for any breach.

DDO obligations applicable to regulated persons that are not insurers (e.g. coverholders and insurance brokers in their own right)

Subject to certain exceptions, the key obligations on regulated persons that are engaged in retail product distribution (that are not insurers) in relation to the TMD product (whether acting for the insurer or insured) are to:

- Not engage in retail product distribution conduct in relation to a product where a TMD has not been made;
- Cease retail product distribution conduct when aware that a TMD is not appropriate;
- Act consistently with the TMD;
- Report certain information to the insurer;
- On becoming aware of a significant dealing in the product that is not consistent with the TMD, report this to the insurer; and
- Update advertising in relation to a TMD product subject to s1018A of the Corporations Act 2001 to include extra information.

The full list of DDO obligations applicable to regulated persons that are not insurers is set out in Appendix 2.

Achieving DDO compliance

Underwriters (through their managing agents) and coverholders are required to comply with the DDO provisions, which come into effect on 5 October 2021. Managing agents and coverholders should liaise with stakeholders to identify how the obligations will be met and by whom. Coverholders and other parties may assist insurers (i.e. underwriters, acting through their managing agent) in meeting their obligations as insurer, but responsibility for any breach and applicable penalties remains with the insurer.

In achieving DDO compliance, managing agents and coverholders are required to review existing retail client products and their distribution arrangements. The DDO obligations are complex and breaches of the new provisions can result in liability through civil penalty proceedings or criminal prosecution brought by ASIC and liability to persons suffering loss or damage through civil actions. ASIC may issue a stop order that specifies conduct not to be engaged in while the order is in force. ASIC can also request information relevant to its regulatory role and make necessary exemptions and modifications to the new arrangements.

In addition, a new retail client product intervention power (PIP) has been introduced under Part 7.9A of the Corporations Act 2001 allowing ASIC to stop the issue of a product that was available for acquisition from 5 April 2019, for up to 18 months where it identifies

significant consumer detriment. This power can be relied on even if a person complies with the DDO or other obligations in the Corporations Act. ASIC recently released Regulatory Guide 272 on this power, which should be considered carefully.

Unfair Contract Terms (UCT) regime

The UCT regime has been extended to cover standard form consumer and small business contracts, covered by the Insurance Contracts Act 1984.

This was achieved by amending the ASIC Act and the Insurance Contracts Act, in response to the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

The regime will apply to relevant insurance contracts that are new, renewed or varied from 5 April 2021.

Standard form consumer or small business contracts

Standard form contracts

The UCT regime only applies to contracts in standard form. A contract is presumed to be in standard form unless one of the parties disputes this.

An insurance contract will be considered a standard form contract as long as the consumer does not have the ability to negotiate the underlying terms and conditions governing the contract, regardless of whether a consumer can select the level of premium, excess or sum insured.

Similarly, an insurance contract can still be a standard form contract if it is intermediated by an insurance broker. Examples of what will be considered a standard form contract are provided in the Replacement Explanatory Memorandum.

Standard form consumer contracts

The extended UCT regime applies to standard form consumer contracts of insurance covered by the Insurance Contracts Act. For the regime to apply, at least one of the parties must be an individual whose acquisition of what is supplied under the contract is wholly or predominantly an acquisition for personal, domestic or household use or consumption.

Standard form small business contracts

The UCT regime applies to standard form small business contracts for the provision of insurance covered by the Insurance Contracts Act. For the regime to apply:

- At the time the contract is entered into, at least one party to the contract must be a business that employs fewer than 20 persons (note that it is the underwriter not the coverholder that is the party to the contract with the insured); and
- Either of the following must apply:
    - The upfront price payable under the contract must not exceed AUD 300,000; or

- The contract must have a duration of more than 12 months and the upfront price payable under the contract must not exceed AUD 1,000,000.

Medical indemnity insurance is excluded from the regime as it is subject to a separate regime under the Medical Indemnity Act 2002.

When a term is considered unfair

The UCT regime in Australia is not modelled on the UK's Unfair Contract Terms Act 1977, which does not apply to terms that "clearly define or circumscribe the insured risk", as these are taken into account when calculating the premium paid. Instead, the Australian model limits the main subject matter – which is excluded from scope - to the description of what is being insured, meaning more terms are open to the challenge of being found as "unfair" in Australia.

Under the Australian UCT regime, a term is void if a court finds that a term is unfair. However, the contract will continue to bind the affected parties to the extent that the contract is capable of operating without the unfair term.

A term of a standard form contract will be considered unfair if it:

- Would cause a significant imbalance in the parties' rights and obligations; and
- Is not reasonably necessary 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.

Before deeming a term unfair, a court is also required to consider:

- The extent to which the contract is transparent – that is, if the term is expressed in reasonably plain language, legible and presented clearly and readily to the party affected by it; and
- The contract as a whole.

Section 12BH of the ASIC Act sets out examples of terms that may be considered unfair. One example is a term that permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract.

In addition, the Replacement Explanatory Memorandum provides a number of examples of unfair terms in relation to insurance contracts. These include terms that:

- Would allow the insurer, instead of making a repair, to 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 for the insured to make the repair;
- Are an unnecessary barrier to the insured lodging a legitimate claim (for example, requiring the payment of a large excess before the insurer considers a claim or requiring the insured to lodge the claim within an unreasonably short timeframe);
- Are in a disability insurance contract, and use an outdated, and therefore inaccurate and restrictive, medical definition to determine whether the consumer meets the criteria to be eligible to have a claim paid; or

- Significantly reduce the cover offered where compliance with the preconditions for being covered is unfeasible (for example, a term in a travel insurance policy that only covers loss of luggage when it has been personally attended by the insured at all times).

Terms exempted from UCT regime

The following terms are excluded from the operation of the UCT regime:

- Terms defining the main subject matter;
- Terms defining the upfront price payable;
- Any term required by a law of the Commonwealth or a State Government; and
- Transparent terms that set an amount of excess or deductible under the contract.

Third party beneficiary changes under the UCT regime

Under the previous UCT regime, a court could only declare that a term is unfair on application by a party to the contract or ASIC. Amendments to the ASIC Act will allow third party beneficiaries of insurance contracts, which are not parties to the insurance contract, to bring actions against insurers under the UCT regime.

An action will only be successful if the tests of unfairness and standard form contracts are met with reference to the parties that negotiated the contracts, not the third-party beneficiary.

Possible further UCT changes arising from small business review

In November 2016, the Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015 extended UCT protections to small business contracts that meet certain criteria. In December 2019, the Government undertook a review of the new protections for small business contracts publishing a consultation paper on Enhancements to Unfair Contract Term Protections.

If implemented, these proposals would affect policies between insurers and insureds, as well as standard form contracts that are not insurance policies such as service agreements between managing agents and coverholders and others subject to the protections.

The consultation paper proposes to:

- Clarify the meaning of standard form contract;
- Change the definition of “small business contract” and clarify the applicable test;
- Modify exempt minimum standards included in state and territory laws from the UCT regime; and
- Strengthen ASIC’s enforcement activities and regulatory powers following ongoing concerns that the current regime does not effectively operate as a deterrent to unfair terms being included in small business contracts.

Achieving UCT compliance

Underwriters (through their managing agents) and coverholders are required to comply with the UCT provisions, which are due to come into effect 5 April 2021. Managing agents and coverholders should liaise with stakeholders to identify how the obligations will be met and by whom. Coverholders and other parties may assist insurers in meeting their obligations, but responsibility for any breach and applicable penalties remains with the insurer.

Practically, underwriters (through their managing agents) and coverholders will need to engage in a review of policy wordings to ensure compliance with the UCT regime, or risk not being able to rely on the relevant terms.

The UCT regime and the duty of utmost good faith under the Insurance Contracts Act operate independently of one another. An insured can still exercise any available right under the Insurance Contracts Act.

Further information

A webinar on the DDO is being arranged and details will be communicated soon.

Contact

This communication is provided for information purposes and is not intended to be a substitute for appropriate legal advice.

If you have any queries regarding this communication, then please contact:

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Appendix 1: DDO obligations applicable to insurers

The DDO obligations applicable to insurers are:

1. To make a target market determination (TMD) for retail insurance types of cover before the insurer or any person engages in retail product distribution conduct in relation to the product from or after the start date.

2. To ensure the TMD meets certain content requirements. The TMD must:
   - Be in writing;
   - Describe the class of retail clients that comprise the target market for the product;
   - Specify any conditions and restrictions on retail product distribution conduct in relation to the product;
   - Specify events and circumstances (review triggers) that would reasonably suggest the determination is no longer appropriate;
   - Specify the maximum period from the start of the day the determination is made to the start of the day the first review of the TMD is to finish; specify the maximum period from the start of the day a review of the determination is finished to the start of the day the next review of the determination is to finish;
   - Specify a reporting period for reporting information about the number of complaints about the product; and
   - Specify the kinds of information needed to enable the person who made the TMD to identify promptly whether a review trigger for the TMD has occurred.

   Decisions on this obligation and TMD content can have a significant impact on end exposure of the insurer and flow on effects for distributors, who will have to report the required information and take reasonable steps to act consistently with the TMD.

3. To make the TMD available to the public free of charge.

4. To ensure the TMD is appropriate. A TMD for a financial product will be appropriate if it would be reasonable to conclude that, if the product were issued or sold in a regulated sale:
   - To a retail client in accordance with the distribution conditions – it would be likely that the retail client is in the target market; and
   - To a retail client in the target market – it would likely be consistent with the objectives, financial situation and needs of the retail client.

5. To review the TMD as necessary to ensure that it remains appropriate (i.e. during the review period, where a review trigger has occurred, or an event/circumstance has occurred that would reasonably suggest the determination is no longer appropriate).

6. Where a review trigger has occurred or the TMD may no longer be appropriate, to:
   - Not deal in, or provide financial product advice, in relation to the product, until they have reviewed the TMD and, if necessary, made a new TMD;

- Take all reasonable steps to ensure regulated persons (e.g. coverholders and insurance brokers and their representatives) are directed not to distribute the product until they are notified that the review is complete, and if applicable, are notified of the new TMD. We note that there is a carve out in relation to persons involved in the provision of personal advice on the product (see Excluded Conduct, as defined in the ASIC Act).

7. To take reasonable steps that will, or are reasonably likely to, result in retail product distribution conduct in relation to the product (other than Excluded Conduct, as defined in the ASIC Act) being consistent with the TMD. This applies to the conduct of the insurer and relevant regulated persons distributing the product. The content of the TMD will have a big impact on obligations in this regard.

8. To collect and keep complete and accurate records of the following information in relation to a current TMD product:
   - The number of complaints in relation to the product that the insurer receives; and
   - The steps taken to ensure consistency with the TMD by the insurer and regulated persons.

9. To keep accurate records of decisions relating to a product's TMDs, review triggers, review period and reasons for those decisions.

10. To notify ASIC of significant dealings that are not consistent with a product's TMD (with the exception of Excluded Conduct, as defined in the Corporations Act 2001).

11. To update advertising in relation to a TMD product subject to s1018A of the Corporations Act 2001 to include a description of the target market for the product or specify where the determination is available (or if the product is not available for acquisition yet, where the description is available).

Appendix 2: DDO obligations applicable to regulated persons that are not insurers

Regulated persons include:

- Licensee agents of insurers (e.g. coverholders) or their authorised representatives or Product Distributors acting under ASIC Corporations (Basic Deposit and General Insurance Product Distribution) Instrument 2015/682); and
- A licensee insurance broker (e.g. when acting on behalf of the insured) and its authorised representatives.

Referrers would not normally be caught as they would not engage in retail product distribution conduct.

The obligations are:

1. Not to engage in retail product distribution conduct in relation to a product where a TMD has not been made and the product is on offer for acquisition to retail clients, subject to certain exceptions (including one where the conduct involves the provision of personal advice).

   If a TMD is not made by an insurer for a product it may be asked to justify its decision by such persons.

2. Where the TMD maker (i.e. the insurer) has taken steps to inform persons not to engage in retail product distribution conduct in relation to the product because the TMD is not appropriate, the person must, as soon as practicable, but no later than ten business days after they first become aware that the steps have been taken, cease to engage in retail product distribution conduct in relation to the product, subject to certain exceptions (including one where the conduct involves the provision of personal advice – i.e. Excluded Conduct, as defined s994A in the Treasury Laws Amendment (Design Distribution Obligations and Product Intervention Powers) Act 2019 (N.50, 2019)..

   Proposed methods of communication will need to be agreed with the insurer to avoid compliance issues.

3. To take reasonable steps that would have resulted in or would have been reasonably likely to have resulted in, the retail product distribution conduct in relation to the product being consistent with the TMD, subject to an exception where the conduct involves the provision of personal advice.

   This involves a consideration of the TMD and what it requires. Depending on the drafting of the TMD by an insurer, a regulated person's obligations can differ significantly.

4. Where the person engages in retail product distribution conduct during a reporting period specified in the TMD, to as soon as practicable, but in any case, within ten business days, after the end of the reporting period, report in writing to the TMD maker (the insurer):
   a. Whether the person received complaints in relation to the product during the reporting period; and

b. If they received such complaints, the number of complaints received (if nil this must be reported);
c. Specified information that the regulated person is required to report under the TMD; and
d. Dates on which the regulated person reported to the TMD maker and the substance of these reports where applicable (except if it is Excluded Conduct as defined in the Corporations Act 2001)

5. If the person becomes aware of a significant dealing in the product that is not consistent with the TMD, to as soon as practicable, and in any case within ten business days, report the dealing, in writing, to the TMD maker.

   Note that significant dealing is not defined in the Corporations Act and is intended to take its ordinary meaning in the context of the new provision.

6. To update advertising in relation to a TMD product subject to s1018A of the Corporations Act 2001 to include a description of the target market for the product or specify where the determination is available (or if the product is not available for acquisition yet - where the description is available).