poor man's

Gillian Moon

Woefully inadequate protection is available to low income consumers of 'investment products'.

Yet another industry has discovered how easy it can be, if the sales pitch is right, to get a great deal of money for little or nothing out of financially unsophisticated consumers.

Most of us probably have not caught up with the fact that selling old fashioned life insurance is now only a small part of the business of the life insurance industry. 'Life offices' are now huge investment houses, selling much more personal superannuation and other investments than ordinary life insurance.

'Investment products'

During the 1970s and 1980s the life insurance industry began to use its agents to sell tens of thousands of 'investment products' to low and lower-middle income earners.

This development needs to be seen in its historical context. The development of hire purchase last century meant that mainstream instalment *credit* became widely available to low and lower-middle income consumers for the first time. Somewhat analogously, the development of personal superannuation and savings plans has made instalment *investment* widely available to low and lower-middle income consumers for the first time.

Until recently there were an estimated 16,000 active life insurance agents in Australia. Recent pressure for reform, particularly from consumer groups and the Trade Practices Commission, has reportedly reduced the number to around half that. The word from the industry is that some of the worst practices have gone into hiding for the moment as well – practices like 'roadside business', where agents drove around looking for builders, electricians and others working on the roadside and used powerful selling techniques to sign them up there and then for personal superannuation or savings plans.

But the problems have certainly not gone away. Life insurance agents are permitted to sell door-to-door, and there are still many vulnerable consumers ripe for selling investment products to.

There are two particularly problematic investment products sold by life offices through their agents:

- personal superannuation is super arranged with a life office rather than directly with the consumer's employer; the consumer contributes small amounts regularly and the policy will mature on retirement;
- savings plans are similar – the consumer agrees to deposit with a life office a certain amount every fortnight or month (say $40) – but the policy is intended to mature after ten years, rather than on retirement. It is a kind of invest-as-you-earn scheme. Savings plans are much the same as unit trusts, except that the funds are invested bit by bit, rather than as a lump sum, and are taxed differently.

Probably the majority of savings plans are education plans, intended to mature around the time the investor's children begin high school or university.

Gillian Moon is a consumer advocate specialising in consumer financial services.

High levels of commissions

What makes these products such bad investments?

The system for paying agents drastically reduces the return on investment which a consumer is likely to get out of personal superannuation or a savings plan. The agent's commission is usually taken out of the initial contributions or savings, and may be as high as 100% of the first year's payments by the consumer. There are thousands of savings plans entered into in the 1980s and early 1990s where the commission was even higher. Many life offices now say that they are moving to spread commission payments over a longer period. While this may improve the early return on investment, the consumer will still pay the same dollar amount overall to the agent.

The amount charged as commission bears no necessary relationship to the 'service' provided by the agent. For the same money, a consumer could buy many hours of expert, totally independent financial advice. Life offices not uncommonly allow agents to select their own commission rates from within a range; needless to say, agents will usually charge what they think they can get away with.

This commission payment system means that there will very often be little or no money invested on the consumer's behalf for some time. It is this which makes these investments so slow in returning a profit to the consumer – it takes years to recover from this initial loss.

Early withdrawal penalty

There is another factor which dramatically reduces the value of savings plans in particular.

The life insurance industry is fully aware of the possibilities for making very profitable use of the aspiration of financially unsophisticated consumers for their children to have a better education or a better chance in life than they have had; it's an effective emotional button to push. Savings plans are also sold by playing on people's guilt about not being 'good savers', and by emphasising the attraction of an imposed discipline in savings.

But life offices impose penalties on consumers who want to pull out before the ten years are up. The Insurance and Superannuation Commission (ISC) has even recommended a formula for life offices to calculate penalties – a graphic illustration of the gap between the ISC's approach to regulation and a consumer protection approach. A consumer who wants to cash in the investment within the first year or two is likely to get nothing back at all, not even the money he or she has put in. After that, although the investment will be in the black, it will be less in real terms than the contributions for at least six years (see the Trade Practices Commission inquiry below).

Under the standard policy, missing even one payment means that the plan lapses and the life office is entitled to treat the contract as terminated. Missing a payment will usually result in the life office sending a letter demanding that the 'arrears' be paid!

The life industry argues that savings plans are medium to long-term investments, not short-term investment and that, although most of the expenses are deducted at the beginning, savings plans will return a profit if regular amounts are paid, as agreed, over ten years. While this is true to an extent, the fact is that this savings pattern does not match the habits and life patterns of most of the consumers savings plans are sold to. Savings plans tie consumers into a compulsory savings regime, locking them in by virtue of their having signed contracts under which they have agreed to save an agreed amount for at least a decade.

When the consumer (predictably) suffers a reduction in income which prevents the making of payments, or decides that the savings would be better invested in, say, a first home, she or he faces losing much or all of the savings.

The life industry is well aware of the unsuitability of savings plans for many consumers' needs. In an inquiry undertaken in 1992 into consumers' experiences with life insurance agents, the Trade Practices Commission found that it takes at least six years for most savings products to break even in real terms, yet more than half are terminated before they get to that stage. As the Commission observed:

> ... much of the (life insurance) industry operates on the expectation that at least one half of its customers in the regular premium ordinary savings and conventional product segments are likely to lose in real terms as a result of their investment in the product.[1]

No doubt some consumers, including young and low income consumers, could benefit from having access to a savings discipline, but this is not the way to do it. There is clearly a mismatch between, on the one hand, what consumers expect and would benefit from in a savings product and, on the other hand, what they are being sold.

Consumer risk

The mismatch is exacerbated by the fact that a wholesale transfer of investment risk from the life office to the consumer has taken place over the last few years, largely through life offices changing their personal superannuation products and their savings plans over to unit-based structures. The entire investment risk is now borne by the consumer – if the life office does not invest wisely or the share market takes a dive, it is the consumer who suffers because the life office gives no guarantees. By comparison, when consumers put their money into bank savings accounts, the investment risk is largely borne by the banks. This safety is surely what the vast majority of those with small savings or superannuation contributions want.

High fees

Another feature which makes both personal superannuation and savings plans poor quality savings vehicles for low income earners is that the fees charged tend to be high, often excessive. The only controls are those resulting from market pressure but, given the complexity of the fee formulae used and the excessively technical, confusing and often misleading way in which fees are disclosed, the market has failed to hold fees down.

Even if fees are disclosed in an understandable way in the policy documents, the documents may not be received until many months after the consumer has signed up. Although there is then a statutory 14-day cooling-off period, it seems rarely to be used and, in the writer's experience, life offices actively discourage consumers from exercising that right. Moreover, it is usually not until the consumer receives his or her first annual statement with the fees set out in dollar form that the size of the fees is understood – at which stage it is too late to make use of the cooling-off period.

Tax detriment

A further feature of savings plans which makes them a poor value investment product is that they are frequently punitive in tax terms for low and lower-middle income earners.

Insurance companies pay tax on their investment earnings at a nominal rate of 39%. The investment earnings which are then credited to the consumer are 'after tax' earnings (a system something like dividend imputation). The consumer is not liable to pay any further tax on those earnings unless funds are withdrawn within ten years of the savings plan's commencement. This 'tax paid' status of savings plan earnings is used as a big drawcard by sellers and agents. Savings plans are expressly marketed as a 'tax advantaged' product.

None of the promotional material the writer has seen for savings plans makes any attempt to point out that, while those on high marginal tax rates can benefit from this tax arrangement, those on low marginal tax rates cannot. For those who do not terminate early, tax will frequently be paid on the earnings at a higher rate than the consumers pay on their other income, including the interest on any savings held in a bank.

In these circumstances, there may be a tax *detriment* flowing from investing in a savings plan. Given that around half of the taxpayers in Australia fall within the 20% or nil tax brackets, and that savings plans are marketed to low income earners, the oral and written representations made about tax advantages by life offices and their agents will be completely false in many cases.

'Utmost good faith'

The problems with personal superannuation and savings plans throw a glaring spotlight on the deficiencies in existing consumer protection law in this field.

The principal consumer protection provision is s.13 of the *Insurance Contracts Act (ICA)* 1984 (Cth), which renders every insurance contract one of the 'utmost good faith'. The biggest problem for consumers seeking relief under this provision is uncertainty as to what the doctrine of 'utmost good faith' means for them.

It is a doctrine which recognises that in insurance contracts, risk passes from one party to another. If the insurer is to agree to take over that risk and to set a realistic premium for doing so, it will need to be assured that the consumer has disclosed all the relevant facts. When this has not happened, the doctrine renders the contract void for want of utmost good faith.

Although the duty of disclosure is said to fall on both parties, there is virtually no judicial interpretation of the doctrine so far as it applies to an insurer's duty to a consumer. Its meaning for low income earners investing in life office personal superannuation and savings plans is anyone's guess.

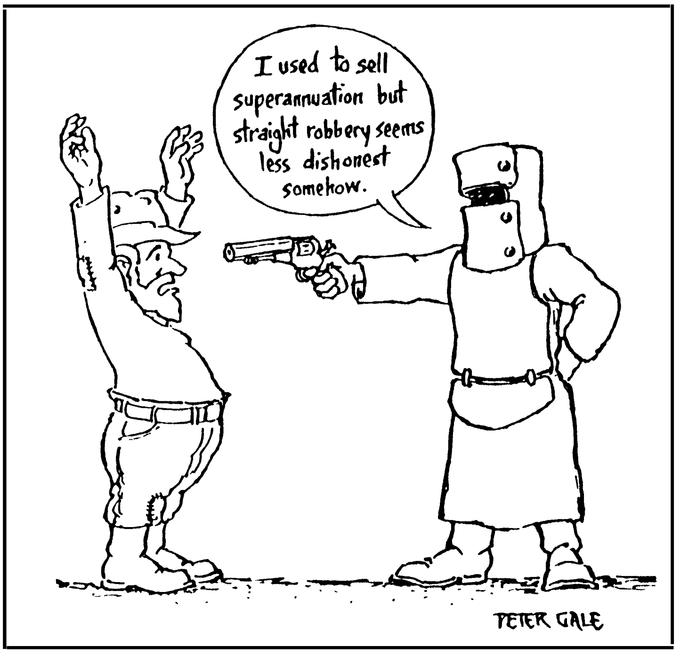
It is a difficult doctrine to apply in practice as a consumer protection doctrine. The duty falls mainly on the consumer, since most of the personal facts which the parties need to know lie in the knowledge of the consumer. By contrast, what might be called the 'contractual facts' lie in the knowledge of the insurer and will usually be disclosed in the contract.

In fact, non-disclosure by life offices is not the problem – the problems are unfair or punitive contract terms, and misleading and deceptive representations, omissions or conduct. When it comes to unconscionable or misleading conduct, can the doctrine of utmost good faith be lifted out of its historical and legal meaning, and interpreted as a more general duty of 'good faith'? When dismissing the consumer movement's concerns about the doctrine's meaning, the regulators seem happy to blindly assume so.

As an alternative analysis, the doctrine is arguably meaningless when applied to investment products like personal superannuation and savings plans because such contracts are not contracts based on an insurance risk.

Unconscionable conduct

For all these reasons, the doctrine is quite unsatisfactory as a consumer remedy, being both uncertain and inappropriate. In modern times, consumers are entitled to the sort of 'tried and true' protection which regimes such as Part V of the *Trade Practices Act (TPA)* 1974 (Cth) provide.



Unfortunately, the previous *TPA* s.52A (the unconscionable conduct provision: now ss.51AA and 51AB) does not apply to insurance contracts because, under s.15(1) of the *ICA*, no insurance contract is capable of being made the subject of relief under that section of the *TPA*. Section 15(1) was introduced as a result of successful lobbying by the insurance industry, to protect insurance companies from the prudential implications (so the industry argued) of having their contracts brought under judicial scrutiny for unconscionability.

But personal superannuation policies and savings plans do contain terms which are, arguably, unconscionable. One example is that of a consumer who took out a savings plan, called a Wealth plan, with Friends Provident.

At the back of her policy was the following section disclosing the fee she was to be charged:

> The charge each month is the sum of the following:
>
> - one twelfth of the Yearly Service Fee
>
> and – prior to the tenth anniversary of the plan only, an amount derived from multiplying $2.57 by the Yearly Contribution (excluding the Service Fee) for the Investment Benefit shown in the Basic Schedule, divided by 100.

The brochure she received at the time had been prepared by Friends Provident's agents, Carlton Ross, and it disclosed the fee in the following terms:

> Assuming you increase your saving input by 8% per annum the monthly administration fee will be no more than 2.57% of your annual contribution plus the service fee which is currently $4.00.

Because she was saving $1320 per year, each *month* she was charged 2.57% of $1320. In plain language, the administration fee was 30.84% of what she saved (2.57% x 12), and she was paying around $440 each year in fees.

A complaint of unconscionable and misleading conduct was lodged with the Life Insurance Federation of Australia's Inquiries and Complaints Service, and yielded the following response:

> The matter was raised with Friends Provident and in their view there has been no misrepresentation by either Carlton Ross or Friends Provident regarding ... charges ... I have carefully studied all the documentation ... and I must agree that the charges are very clearly spelled out ...
>
> In your letter you refer to 'an innocuous 2.57% monthly administration fee' and contend this turns out to be 30.84% per annum. I agree and find it difficult to understand why 2.57% per month could be taken to mean anything other than 30.84% per annum.

Under the current law, this consumer could not seek relief under *TPA* s.52A. However, there are ways around *ICA* s.15(1). For example, consumers still have access to the common law doctrine of unconscionability, and the above Friends Provident clause is arguably misleading and deceptive as well as unconscionable.

But behind all this is a big question as to whether savings plans and personal superannuation are 'insurance contracts' anyway. If they are not, then the *ICA* (including the restriction on relief under *TPA* s.52A) will not apply to them.

But is super 'life assurance'?

The question of whether personal superannuation is 'life assurance' within the meaning of that phrase as used in s.116(2)(b) of the *Bankruptcy Act* 1966 (Cth) recently went before a single judge of the Federal Court, who ruled that it was not life assurance. On appeal, the Full Federal Court held unanimously that it was.[2] The question is now on appeal to the High Court. The public policy issues raised in this case – the judges placed great weight on the importance of protecting retirement funds from creditors in a bankruptcy – are somewhat different from those raised in considering consumer protection for low income buyers of life office investment products.

On the subject of savings plans, many contain no insurance provisions whatsoever, and it is hard to imagine how those savings plans could possibly be called life insurance. Others contain a kind of 'death provision' which, although couched in insurance language, is probably not life insurance. Under these contracts, the insurer merely agrees not to impose an early termination penalty if the consumer dies before the investment matures.

Even where honest-to-goodness life insurance is part of the deal contracted for, that does not necessarily render the entire contract one of insurance for the purposes of the *ICA*. In most the life insurance is incidental, the contract being principally a unit-linked investment contract. Unfortunately, the Federal Government is planning to amend the *Life Insurance Act* 1945 (Cth) to say that anything sold by a life office is 'life insurance' for statutory purposes. This may be a neat political solution, but it leaves low income consumers very vulnerable to unscrupulous life offices using their agents to over-sell poor value investment products.

What should be done?

The incentives to agents to oversell have been reduced. To their credit, many life offices have made moves over recent months to reduce the commissions they pay their agents, or at least to spread payment over a longer period. But the fundamentals which allowed the exploitation in the 1980s are still in place. The door-to-door selling of these poor value products, geared for sale to the more vulnerable, remains unchecked; it is only the current spotlighting, rather than any consumer pressure in the market, which has forced commissions down for the moment. The available consumer protection is still woefully inadequate.

The tens of thousands of consumers who were sold savings plans over the past decade or more must be remembered. Many paid huge agents' commissions, were the victims of systematic misleading and deceptive practices by agents, and entered into contracts containing terms which were unjust on any view.

Who can help these people? These consumers have nowhere to go for assistance: many of the organisations which receive complaints simply refer the complainants on to other organisations which also cannot help them.

The Trade Practices Commission recently called for the establishment of a specialist life insurance and superannuation legal centre or centres, as did both the Senate Select Committee on Superannuation,[3] and the recent review of the life insurance industry's own complaints and disputes scheme.[4] The consumer movement has now asked the Federal Government to provide funds to enable community-based advocacy and litigation centres to be set up to help consumers who have been sold personal superannuation or savings plans by life insurance agents.

Often what is needed is simply an independent person, familiar with consumers' legal rights and with the way the life industry operates, to negotiate a fair outcome with the particular life office. At other times it would be enormously useful for test cases to be run to clarify questions such as: are unfair contract terms in breach of the duty of utmost good faith; are early termination penalty clauses enforceable; and what compensation is available to a consumer who is a victim of misrepresentation by an agent?

The Federal Government must move to give consumers the tools they need to protect their own interests in the life insurance market place – access to *TPA* s.52A and a community-based litigation and advocacy capacity. Consumers are not asking resource-strapped governments to do everything for them. They just want the basic equipment to be able to fight their own fights.

References

1. 'Life Insurance and Superannuation', Trade Practices Commission, December 1992, pp. 71-3.
2. *Re Barrett; Ex Parte Young v National Mutual Superannuation Pty Ltd* (1922) 34 FCR 508; *N M Superannuation Pty Ltd v Young* (1993) 41 FCR 182.
3. 'Super Supervision Bills', Ninth Report of the Senate Select Committee on Superannuation, October 1993, Recommendation 17.1.
4. Review undertaken for the Insurance Industry Complaints Council by Issues Australia, April 1993.