Greg Martin, ClearView

Greg Martin has more than 30 years' experience in life insurance and funds management. His current responsibilities include overseeing ClearView's actuarial team, group risk management and compliance team, and life and wealth product team. Greg is also a director of ClearView's two financial advice businesses. Prior to joining ClearView in 2011, he was a partner of KPMG, where he provided actuarial advice to the industry for 17 years. He has held 10 appointed actuary roles during his career and been a member of various regulatory, industry and professional committees and boards, and published a number of industry related papers.

ADVICE CULTURE AND REMUNERATION

The shameless truth about life insurance commissions

Greg Martin

Introduction - The psychology behind good and bad advice

We are all motivated reasoners and our motivation is rarely simply financial. Life insurance commissions, much like Satan and the universe, are too frequently blamed for a wide range of ills and calamities. The devil, for example, is blamed for a host of trials and tribulations: infidelity, addiction and temptation, when the root cause, more often than not, is personal failings.

Similarly, the commission model gets the blame for poor advice, poorly documented and delivered advice, no advice and lapse rates when objectively it isn't responsible for the life insurance industry's myriad of problems. Pointing the finger of blame at commissions may be convenient but it is too simplistic and doesn't address the real issues.

The truth, based on the science of psychology, is that remuneration and monetary reward is not the key driver of human behaviour. Suggestions that human behaviour is all about financial incentives, like commission, seem to be based on a presumption that human behaviour mirrors relatively simple rules that are often seen in animal experiments such as Pavlov's dogs and Skinner's theory on operant conditioning.

This has led to proposals to limit and restructure all sorts of remuneration models including commission and executive incentive structures, based on the misguided belief that if human beings are simply rewarded and incentivised in the right way, the output will be the right behaviour.

But humans are not as simple as Pavlov's dogs or Skinner's rats. According to the field of cognitive science and social psychology, we are all motivated reasoners but our motivation is rarely simply financial. The strongest motivating factors relate to tribal membership and alignment, identity and a sense of belonging.

In terms of organisations and professions, values and culture play a huge role, indeed the denominating role, in shaping behaviour.

This is explored in greater detail below but at a high level, if a culture is unsound then a remuneration structure won't fix it.

On the flipside, if a culture is sound, the remuneration structure shouldn't matter much. It is critical that any reform agenda addresses the real problems and enacts real change. If not, it will only increase business costs, which means higher costs to consumers.

The quote

Further reductions in commissions would mean those left would need to focus on affluent clients who can afford to pay fees.

This paper aims to:

- Correct the misconception that commissions are the key driver of poor client outcomes;
- Identify the real cause of poor advice;
- Demonstrate the importance of culture and membership in driving performance;
- Highlight the likely unintended consequences for consumers and advisers if there are further
- Overall reductions to life insurance commissions; and
- Discuss the benefits of variable remuneration.

Consumers and advisers to feel the pain

Section two – 'The consumer and adviser experience' – goes through the findings of a recent survey conducted by ClearView between 16 April and 8 May 2019. Over 630 self-employed advisers completed our questionnaire, sharing their concerns and details about their business.

The 2019 Adviser Experience Survey found that, if poorly implemented, the Royal Commission's proposed recommendations will have a devastating impact on both advisers and consumers. Further changes to adviser remuneration will make life insurance advice even more inaccessible and unaffordable to consumers. It will threaten the commercial viability of many advice practices, with over 98 per cent of financial advisers reliant on life insurance commissions and fewer than 2 per cent currently charging a fee for service (see below).

Unsurprisingly, the overwhelming majority of financial advisers are in favour of retaining upfront commissions. But before dismissing this as self-interest, let's consider some of the issues. Advisers are biased towards commissions in the same way policy makers who are paid salaries, and their consultants, who are paid either a salary or fee, are biased toward their form of remuneration.

According to Yale Law School Professor Dan Kahan, who studies the application of decision science in law and policy making, human beings show favouritism and bias towards their way of doing things and can quickly form an 'us versus them' mentality which makes it difficult for them to see those outside their 'group' as individuals with good characteristics and qualities.

Knowing this, public policy must be shaped with input from different groups to assist in mitigating prejudice and discrimination. Given potential changes to upfront life insurance commission caps will directly impact 74 per cent of advice businesses (see Figure 1), policymakers must be conscious of their biases.

They also need to understand that advisers, when providing life insurance advice, can't simply replace commission revenue with fee revenue in the same way they have been gradually doing with investment advice, since the Future of Financial Advice (FoFA) regime commenced in 2012.

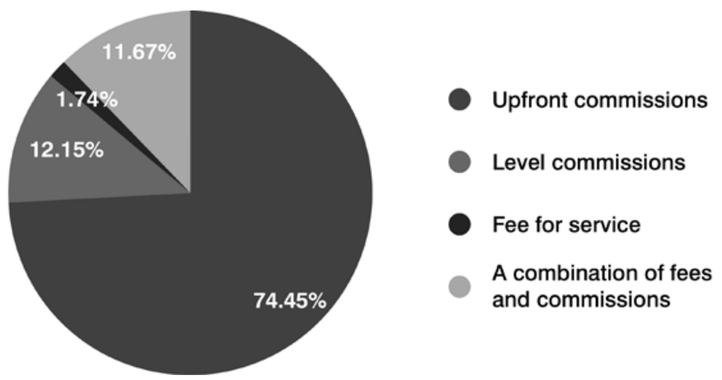
For superannuation and investment advice, a client can fund an explicit advice fee from the capital within an investment portfolio or super fund arrangement. Where there is no associated 'capital sum', as in the case of an insurance policy, consumers need to transfer funds or pay out of their hip pocket. That's an upfront cost of roughly $1,750-$2,875 for a typical life insurance policy.

Economically, it makes sense for a life company to fund that cost. The 'cost of capital' for an institution funding the upfront cost is significantly less than the value to the customer of making the equivalent upfront payment.

To complicate matters further, with life insurance advice, a great deal of work is done before a policy can be issued and there is no guarantee that a client will proceed to cover. Some clients choose not to proceed. Others are unable to pass the underwriting process.

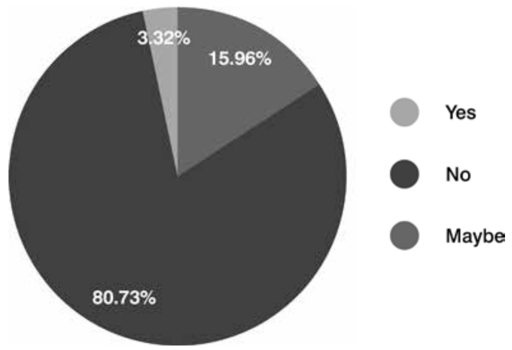
An institution funding the upfront cost associated with securing life insurance is the reason initial commissions were originally invented. According to the 2019 ClearView Adviser Experience survey, more than 80 per cent of advisers do not believe many clients will pay a fee for life insurance advice (see Figure 2).

Figure 1. When providing life insurance advice, how do you primarily charge?



Source: ClearView 2019 Adviser Experience Survey

Figure 2. Do you believe clients will pay a fee for life insurance advice?



Source: ClearView 2019 Adviser Experience Survey

If life insurance commissions were banned or subject to further changes, 54 per cent said they would stop providing standalone life insurance advice. Many dedicated life insurance specialists, of which Investment Trends estimates make up 15 per cent of the market, are already expected to exit the industry.

Further reductions in commissions would mean those left would need to focus on affluent clients who can afford to pay fees. The likely impact of these changes would be a further blow-out to Australia's underinsurance gap, which Rice Actuaries estimated in 2015, already exceeded $1.8 trillion in cover shortfall. Since then, new risk premium written in the retail market has reduced 30 per cent, indicating the underinsurance gap is growing with the reforms already in train. It can only get worse with further commission reductions and adviser exits from the industry.

This is a key reason why life insurance commissions were originally exempt from the FoFA reforms. At the time, the Labor government concluded that upfront commissions had to remain because of the complexities of life insurance products, the nature of the advice required and the potential to exacerbate Australia's already serious underinsurance problem.

For more on the potential consequences of further changes to commission caps, see Section three – 'The industry and economic impact'.

Section one – Culture: the first line of defence

Management guru Peter Drucker famously said 'Culture eats strategy for breakfast' but culture eats everything for breakfast, lunch and dinner including remuneration structures. The link between advice quality and remuneration is tenuous at best.

However, three major reports in the past five years seem to presuppose that life insurance commissions influence advice and are a lead indicator of poor consumer outcomes. They are:

- ASIC Report 413: Review of retail life insurance advice;
- Financial System Inquiry (**FSI**); and
- The Trowbridge Report for the Life Insurance Advice Working Group (**Trowbridge LIAWG**).

ASIC Report 413 found 37 per cent of files it reviewed between September 2013 and July 2014 failed to comply with the rules governing appropriate and compliant advice. Pleasingly, Report 413 also highlighted the value of personal life insurance advice. The report described good advice as:

- Tailored to the client's personal circumstances, budget and goals;
- Balanced against a client's other competing priorities; and
- Leaves the client in a better position.

Assuming that 63 per cent of files reviewed by ASIC passed the test, it is still a damning report card. That said, it is reasonable to expect that advice quality and advice processes have improved in the years since the release of Report 413.

There has been heightened regulatory focus on best interest duties, tougher file documentation focus, and we are now mid-implementation of higher qualification and professional standards, under the Financial Adviser Standards and Ethics Authority (**FASEA**) regime.

Are fees the magical silver bullet?

The question is; would those behind that poor advice noted in Report 413, magically give quality advice if they were paid a fee instead of commission?

It's not hard to find many examples of excellent advice, across multiple different fields, where an adviser or service provider has been paid a fee. There are also many examples of excellent advice, across multiple different fields, where an adviser or service provider has received a commission.

Equally, poor advice is not confined to a specific remuneration method. Consider the doctor who misdiagnoses a patient, the solicitor who prepares a sub- standard contract or the accountant who misinterprets a tax ruling.

In each of these real scenarios, no-one blames the fee model. They blame the practitioner. Contributing factors may include organisational culture and outdated processes. In short, quality advice is dependent on:

- An individual's knowledge, skills and experience;
- An individual's professional values and ethics; and
- The culture of the professional eco-system they operate in.

Get those three things right and the method of remuneration may be largely irrelevant.

Tinkering with remuneration over the past decade has not resulted in major improvements to advice quality and consumer outcomes.

In the investment space, commissions were swapped for fees, and now the industry is grappling with the issue of 'fees for no service', and other advice problems.

As Royal Commission testimonies showed, the industry's problems relate far more to vertical integration, poorly managed conflicts of interest, system failure, lack of investment and attention on risk and compliance, and directors and trustees not understanding their fundamental obligations. In truth, we keep coming back to skills, professionalism, systems and poor culture.

Does the commission model attract the wrong types?

Financial advisers are a disparate bunch. Unlike accountants, actuaries and lawyers who are often the subject of light-hearted jokes because many of them share common characteristics and attributes, financial advisers are hard to stereotype.

At the current time, they're not unified under a single professional body. They don't hold the same qualifications. They're not guided by the same principles. As a result, the industry hasn't been able to form a strong, unified culture.

According to Henri Tajfel's social identity theory, membership to a particular group is an important source of pride and self-esteem. Social identity theory explains how an individual forms their views of the world, why they react in a certain way to information and their intergroup behaviour.

Tajfel argued that members of a group act to enhance their group's image. This leads to stereotyping which is based on normal cognitive processing and tends to exaggerate the:

- differences between groups; and
- similarities of the same group.

While it's human nature for groups to form an 'us versus them' mentality, which in extreme cases can be destructive, it can also be powerful. Consider the legal profession. Would-be lawyers go to university and train in that profession.

During these formative years, the profession's norms and expectations are inculcated into them through formal tertiary education and later via professional bodies.

They complete practical training before taking an oath and being admitted to the Supreme or Federal Court to practice in their jurisdiction. They're issued with a practicing certificate from their

Law Society or equivalent association. Lawyers must complete ongoing training and reaffirm their commitment to the legal professional standards every year.

As a result, lawyers are considered to be highly-educated and professional. Television shows depict them as such and tens of thousands of high school leavers apply for law degrees. To foster a positive image of lawyers and protect its membership, the 'Law Societies' actively discipline and disqualify members which it deems are not fit and proper.

The legal profession is an example of Tajfel's social identity theory in practice. According to Tajfel, the strongest motivating factor for human beings relates to tribal membership and alignment, not simple monetary reward. In other words, reward does not drive behaviour.

Consequently, if the culture is sound, remuneration structure may not matter. However, if culture is unsound, a remuneration structure won't fix it.

The question then is not; does the commission model attract poor performers but rather how can the advice industry create a strong culture that attracts ethical, like-minded people? The FASEA regime is a critical step towards that.

It will ensure that all advisers hold the same minimum education and training qualifications, and adhere to the same Code of Ethics. This will boost the sector's credibility and performance in a way that tinkering with remuneration is unable to do.

The science of psychology tells us that success in driving the behaviour of individuals in an organisation or profession depends on the extent that an individual identifies with their tribe. If the identification is strong, individuals will typically behave in a way that aligns them with their tribe in a bid to achieve belonging and status inside that group.

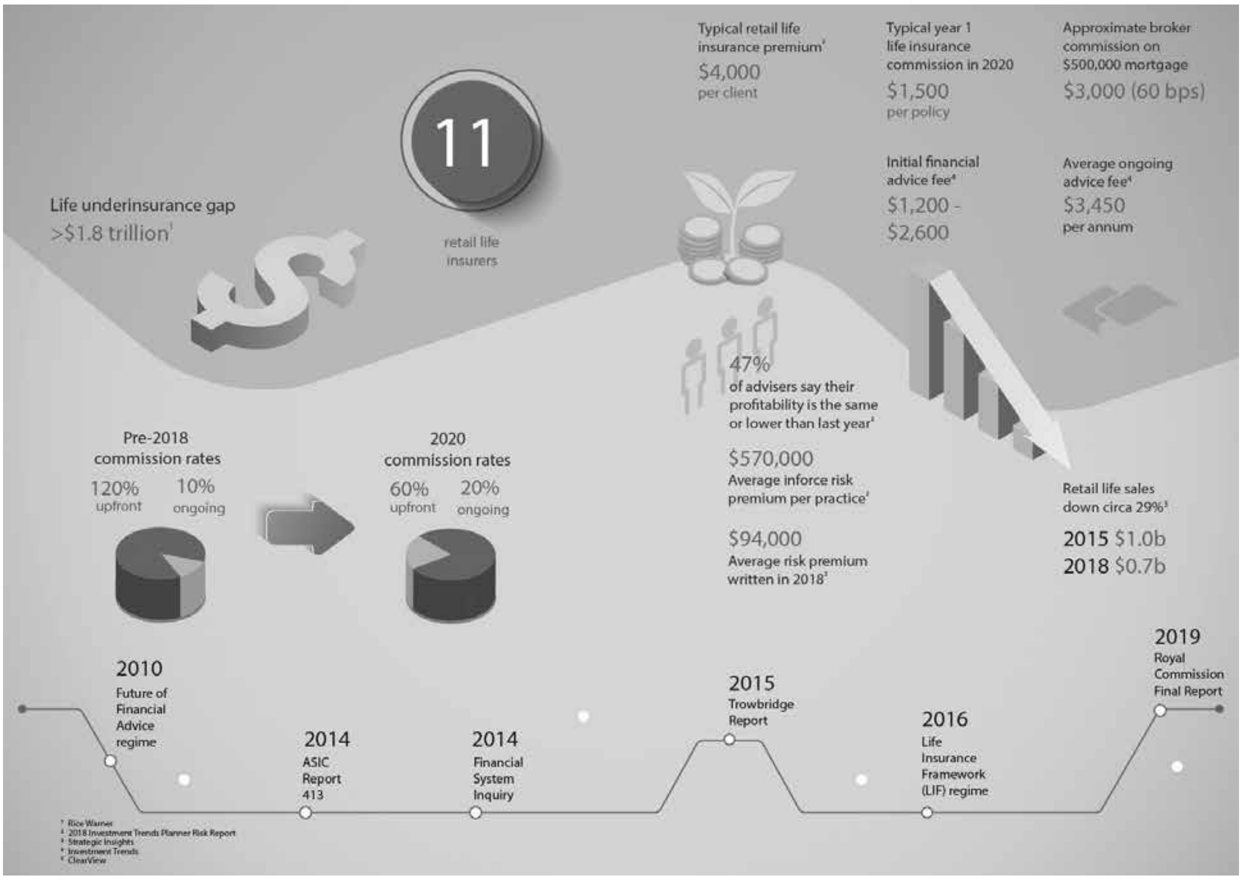
In that sense, an organisation's culture, norms of behaviour and attitudes become the key behavioural drivers and depending on the circumstance remuneration may have no influence at all.

For this reason there are relatively low incidents of bona fide professionals such as accountants, doctors and lawyers providing poor advice to their clients, despite operating in private practice and effectively earning pure variable remuneration, which is business fees - expenses.

To achieve the same outcome in financial advice, advisers need to feel like they belong to a tribe, seek their self-regard from their tribe, and the tribe to espouse and actually pursue professional standards. Financial advice needs to become a genuine profession.

In this context, one of the weaknesses of the current advice regime being pursued is that licensing of advisers is to remain via regulators and 'licensees'. This is not the best way to develop a professional advice tribe – it would be much better if adviser associations provided the basic 'entry point licence'. That would give the associations – the adviser tribes – professional teeth and real accountability!

Figure 3. Australian life insurance industry snapshot



Section two - The consumer and adviser experience

Unpacking the ClearView 2019 Adviser Experience survey

Of the Royal Commission's 76 recommendations, it is recommendation 2.5 on life risk commissions that financial advisers are most concerned about.

Recommendation 2.5: Life risk commissions

When ASIC conducts its review of conflicted remuneration relating to life risk insurance products and the operation of the ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, ASIC should consider further reducing the cap on commissions in respect of life risk insurance products. Unless there is a clear justification for retaining those commissions, the cap should be ultimately reduced to zero.

That's not surprising given the majority of financial advisers depend on commissions to pay for their life insurance advice.

The case for upfront commissions

The high percentage of advisers who opt for upfront commissions (74 per cent) reflects the high cost of providing initial advice due to the work and time required to assess a client's insurance needs, and arrange and implement life insurance.

According to the 2019 ClearView Adviser Experience Survey, in 33 per cent of cases, it takes 5-6 weeks for an adviser to implement cover for a client - from the initial meeting to policy acceptance.

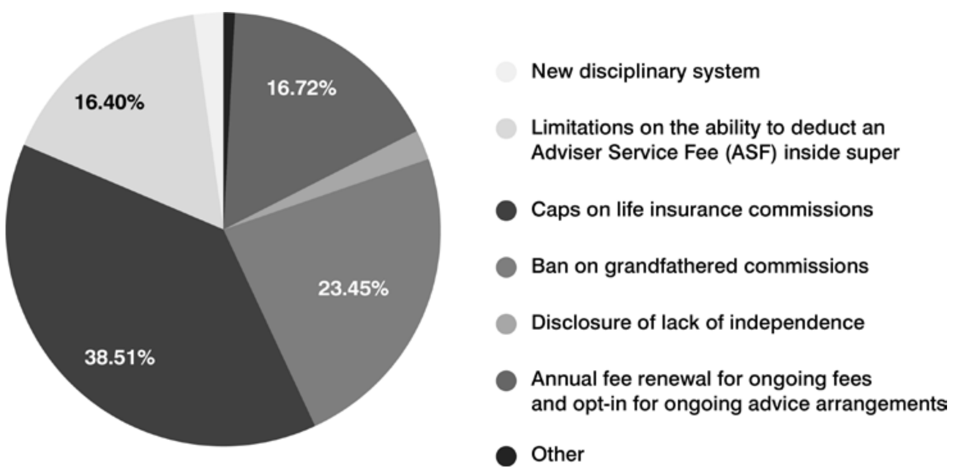
In 31 per cent of cases, it takes 6-8 weeks and in 14 per cent of cases, it can take over two months.

The high cost of providing upfront advice was recognised by the Trowbridge LIAWG which supported some form of meaningful upfront payment. However, advisers are currently adjusting to reduced upfront commission caps and strict clawback provisions, under the LIF reforms (see table below).

Table 1. Life Insurance Framework commission caps

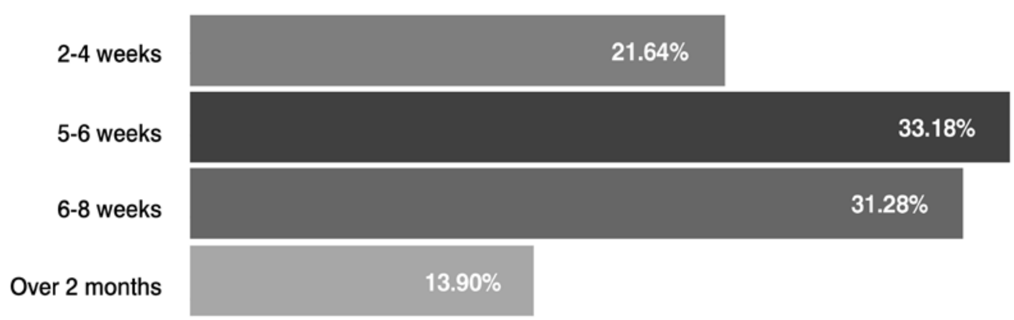
Date effective	Maximum upfront commission rate
1 January 2018	80%
1 January 2019	70%
1 January 2020	60%

Figure 4. Almost 40 per cent of advisers listed recommendation 2.5 as their primary concern



Source: ClearView 2019 Adviser Experience Survey

Figure 5. What is the average time it takes for your firm to complete the process to secure cover?

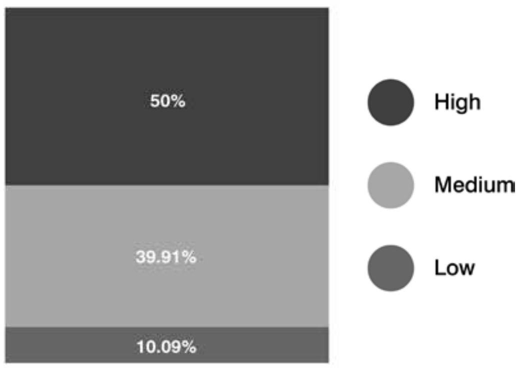


Source: ClearView 2019 Adviser Experience Survey

From 1 January 2020, upfront commission caps will ratchet down again to 60 per cent of first year's premium. This compares to historical commissions of up to 130 per cent of first year's premium. Advisers are concerned that there is no bandwidth for further changes.

A key feature of LIF is that it removes competition issues from commission rate discussions by mandating uniform commission rates irrespective of the life insurer.

Figure 6. Half of advisers describe the impact of LIF on their business as 'high'

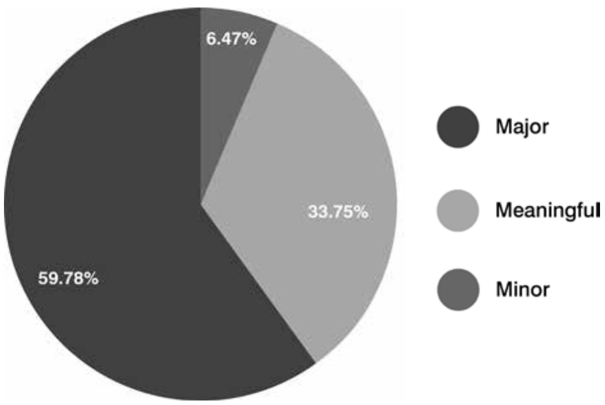


Source: ClearView 2019 Adviser Experience Survey

Royal Commission recommendations

Almost 60 per cent of advisers indicated the implementation of the Royal Commission's advice recommendations will have a major impact on their business if introduced in the next 12 months.

Figure 7. Describe the impact of the Royal Commission's recommendations on your business



Source: ClearView 2019 Adviser Experience Survey

In addition to managing regulatory change and the rising cost of providing advice, advisers need to manage the risk of not getting paid at all given that policy acceptance is far from guaranteed.

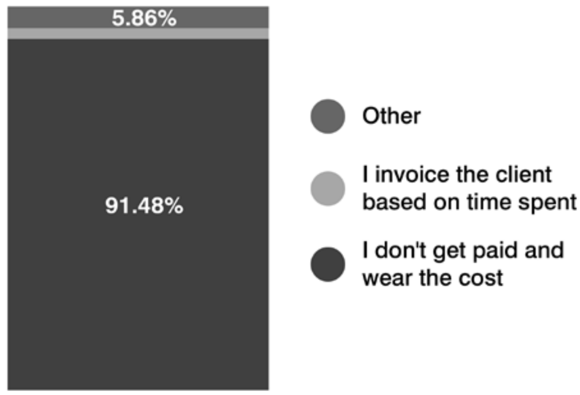
Almost 40 per cent of advisers surveyed by ClearView indicated that 1 in 10 clients did not end up proceeding to cover for a range of reasons. A further 33 per cent of advisers said this was the case for 1 in 5 clients.

Figure 8. How often are you unable to secure cover?

Source: ClearView 2019 Adviser Experience Survey

In situations where they had done the work but cover could not be secured or the client decided not to proceed, over 91 per cent of advisers did not get paid. This is a key risk for advisers given a life insurance Statement of Advice (SoA) takes at least 3-4 hours to prepare and requires a significant amount of research on top of that.

Figure 9. In situations where cover is not secured, how are you remunerated?



Source: ClearView 2019 Adviser Experience Survey

The small proportion of advisers who received some form of remuneration, described it largely as nominal and by no means reflective of the work done. Typically, a small fee could only be recouped from a client where life insurance advice formed part of a broader Statement of Advice (**SoA**).

While advisers are being forced to consider charging a fee irrespective of whether a client proceeds or passes underwriting, many said clients did not like this and it acted as a deterrent to clients seeking advice and/or proceeding to application.

Such a scenario is akin to an optometrist offering to test a patient's vision and attempt to find suitable glasses but requiring payment even if no glasses are provided.

Ongoing commissions: fees for no advice?

The life insurance industry has historically represented trail commissions as a payment to advisers in the event they need to help a client lodge and manage a claim. But in today's environment, many advisers routinely do more.

When asked to pick the two main services they provide for their ongoing commissions, the top three responses were:
1. Offer of an annual review of insurance arrangements;
2. Assist with queries, administration and policy variations; and
3. Assist with claims as they arise.

Most advisers do not charge a fee for claims management because they see it as part of their value proposition and an obligation they fund from the ongoing commissions they receive from all of their clients.

Section three - The industry and economic impact

Data from the Australian Prudential Regulation Authority (APRA) shows that the Australian life insurance industry is struggling with falling profits. The industry also has falling retail sales. This is largely due to:
- Unsustainable products and pricing;
- Weak new business sales;
- Heightened claims volatility; and
- Elevated lapse rates.

For the year ended 31 December 2018, the Australian retail life risk insurance market reported aggregated industry losses of $65.7 million.

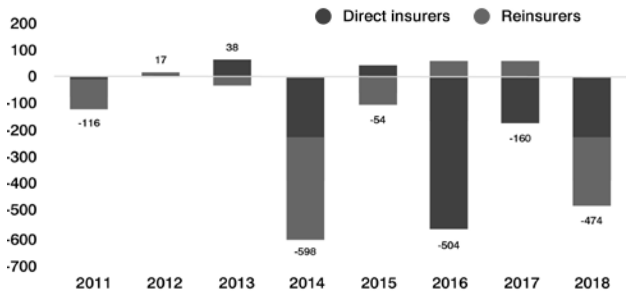
In May 2019, concerned about the long- term viability of insurers, APRA wrote to all life companies calling for a review of income protection products and pricing.

The letter stated: 'The life insurance industry's failure to design and price sustainable individual disability income insurance (DII) products has been an area of heightened focus for APRA. Beyond the pressure of financial performance… APRA is concerned that product design and pricing decisions may be contrary to the long-term interests of policyholders'.

In this challenging environment, additional changes to the way life insurance is sold in Australia (and so soon after LIF) may see the profitability and sustainability of life companies deteriorate further.

If ASIC Report 413 and the FSI in 2014 deemed it dangerous and unnecessary to ban commissions and the Trowbridge Report, released in 2015, came to the same conclusion, now is definitely not the time to tinker with commissions caps.

Figure 11. Individual DII net profit/loss after tax - 12 months to 31 December ($m)

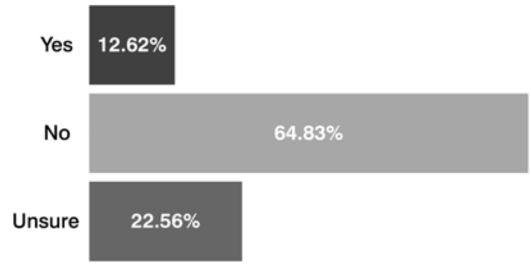


Source: APRA thematic review of individual disability income insurance - phase two

Key concerns throughout all three reports were that:
- Remuneration models needed to be sustainable to prevent advisers from exiting the industry;
- Removing commissions would dissuade consumers from buying life insurance; and
- Further changes would exacerbate Australia's already severe underinsurance problem.

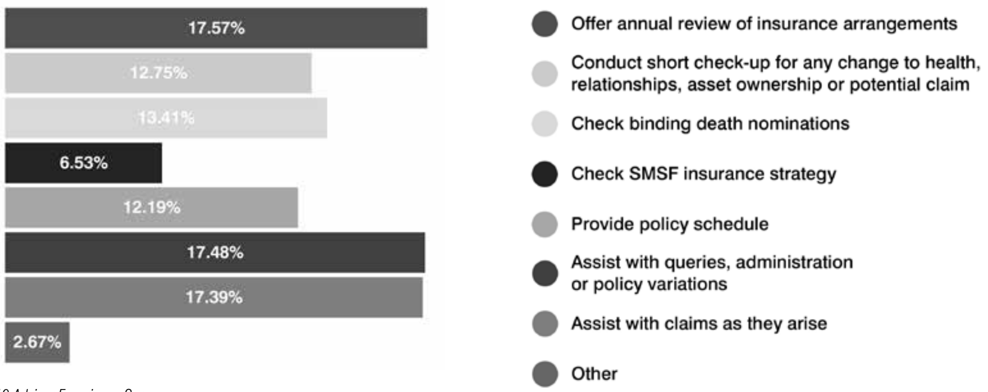
Their concerns are even more poignant today. According to the ClearView Adviser Experience survey, 65 per cent of advisers have no intention of changing the way they charge for insurance advice, 23 per cent are unsure and only 12 per cent plan to make changes.

Figure 12. Do you intend to change the way you charge for life insurance advice?



Source: ClearView 2019 Adviser Experience Survey

Figure 10. What are the two main ongoing services you provide to clients where you are receiving an ongoing commission?



Source: ClearView 2019 Adviser Experience Survey

If life insurance commissions are subject to further caps or banned entirely, 55 per cent of advisers will cease providing standalone life insurance advice.

While ClearView is supportive of any reforms that aim to strengthen consumer protections and address poor practices, we believe current life insurance commission caps are appropriate and should remain in place. We would like to see a period of stability for the life insurance and advice industry.

We reject the suggestion that upfront commissions encourage or lead to poor behaviour and consumer outcomes. It is unnecessary, and far too early, to consider tinkering with commission caps again given the LIF reforms are only partly implemented and won't be fully implemented until 2021.

Any review into the effectiveness of recent regulatory reforms on the quality of advice should take place well after 2021, given it will take some time for the impact of all these changes (including FASEA) to be apparent.

It is important that the review focuses only on advice provided after 2020 to accurately measure the effectiveness of LIF. The review should also assess the impact of regulation on Australia's underinsurance problem.

Conclusion - Avoiding unintended consequences

The current upfront commission structure is widely-accepted, economically rational and reflects what consumers actually want. It is unfortunate that much of the public discourse around the behaviour of advisers has focused so much on remuneration and less on the role of industry culture and norms.

This paper is not suggesting that a remuneration structure can't exacerbate a poor underlying culture construct or weak personal ethics. There is no doubt that extreme remuneration structures can be too tempting for some, leading to manipulation and fraud.

Furthermore, a remuneration structure, such as commission, can help re-enforce an underlying poor culture. This paper merely aims to highlight the importance of tribalism and culture in driving behaviour and improved outcomes.

There must be a proportionate amount of time and attention spent addressing the real drivers of human behaviour to avoid reforms that are ineffective and result in adverse unintended consequences.

As Willis Towers Watson's Jeremy Forty and Keith Walter pointed out in their 2011 paper: New approaches to compensation, regulators must be mindful of the risk of adverse outcomes when considering changes to the commission model.

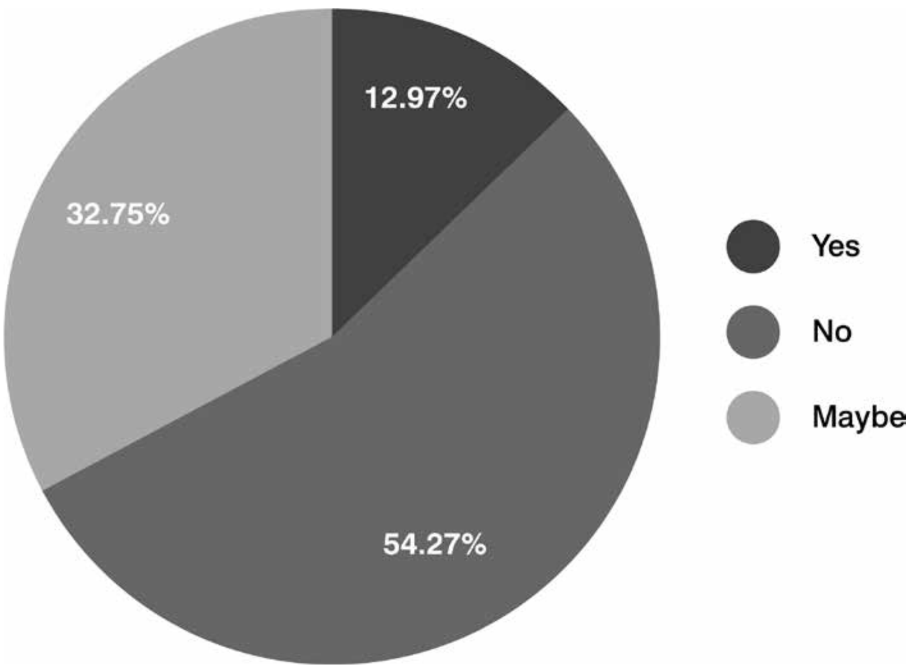
Some of these likely unintended consequences included:

- Putting professional advice out of reach for the average person, given they don't have the discretionary income to pay for it;
- Downward pressure on the profitability of advice businesses;
- The premature exit of hundreds of advisers;
- The exacerbation of Australia's underinsurance problem; and
- The burden of caring for the sick and destitute falling on families, society and the government. Life insurance is an important pillar in Australia's social security framework.

Forty and Walter added that it would lead to a fundamental change to the way life insurance is distributed and restrict some insurers' market access. This would result in further consolidation and a 'loss of competitiveness… with a bleak long-term outlook'.

They flagged the possible reintroduction of tied agents, as product

Figure 13. If life insurance commissions are subject to further caps or banned, will you continue to provide standalone life insurance advice?



Source: ClearView 2019 Adviser Experience Survey

manufacturers are forced to own distribution in order to secure market access and direct customer relationships.

The effect of this will drive control of the market into the hands of the 'big end of town' and create new and higher barriers to entry. All of this undermines the value and importance of objective personal advice, not to mention the importance of fostering competition and innovation in the marketplace.

For too long the value of life insurance and the benefits of professional advice have been overshadowed by the commission debate. Anyone who has received life insurance benefits, or knows someone who has received life insurance benefits, knows that life insurance makes a huge difference in people's lives.

Sensible public policy should encourage and facilitate the purchase of appropriate life insurance coverage by more Australian households.

Commission as a business cost management model

Public policy should also promote sound, sustainable business management. Today's commission debate forgets that variable remuneration structures including executive bonuses link 'costs' to 'income' or 'success' and allow businesses to better manage their revenue and profitability.

Where a business pays a commission on sales, the more goods and services sold, the higher the costs. Equally, reduced sales mean reduced costs. The same principle applies for variable executive bonuses linked to a company's profit or share price. This means companies pay more when they are performing strongly and pay less during tough times.

However, businesses that pay only fixed remuneration carry all the risks of sales and profit variability. This makes them less stable and often more highly geared. It tends to bring forward costs and increase the risk of failure. In a downturn, it exacerbates the need to lay off staff.

Any debate about the validity of life insurance commissions must recognise that commissions are not purely a sales incentive mechanism. The wide-spread use and acceptance of variable remuneration structures across most industries demonstrates their legitimacy as a business risk management tool.

Prohibiting or limiting the use of variable remuneration structures will only increase business risk and costs. Consumers will bear the brunt of these costs. The hallmarks of a successful business that provides a valuable service to society include a high-performance, customer-focused culture alongside good business and risk management.

Australia's vibrant and thriving financial services industry has been built largely on entrepreneurial self-employed financial advisers.

Putting aside the difficulties of implementing a fee-only advice model, which have already been explored in this paper, if commissions were reduced further, the industry may be forced to shift to a salaried adviser model. This approach would certainly lead to:

1. Increased business risks and costs for life insurers which will ultimately be borne by consumers.
2. Less innovation and competition as only the largest institutions will be able to survive. Smaller players and new entrants will be casualties.

The financial services industry, including its regulators, must address the real causes of poor advice. If they simply move to ban or further reduce life insurance commission, it will only lead to increased business costs, increased costs to consumers, less innovation and competition, and fewer Australians with adequate life insurance cover. **FS**