QFE insurance providers' replacement business practices

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Findings from our review of QFE insurance providers' processes for replacement business in the life insurance industry

FMA
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Contents

Executive summary **1**
Purpose of this thematic review 1
What we looked at 2
What we found 2
Our expectations 3

Introduction **4**
Background 4
Why we conducted this review 4
Population 6

What we found **8**
Insurance replacement business definition 8
Identifying and monitoring replacement business 8
Identification 8
Processes 9
Differences among distribution methods 12
What controls QFEs use 12
What actions do QFEs take when issues are identified? 14

Our expectations **16**
Concerns that need to be addressed 16
Next steps 16
Future changes to the insurance sector in New Zealand 17

Glossary **18**

Executive summary

Purpose of this thematic review

In the year to September 2017, New Zealand consumers spent $2.2 billion[1] on annual premiums for life insurance policies. Our previous research has shown that a significant percentage of policies were shifted during the year from one insurance provider to another.

We have previously raised concerns about the risks from this 'replacement business' in the life insurance industry[2], notably when sales appear to be motivated by upfront commissions and other soft commissions offered by providers for reaching specific sales targets. We believe this drives conflicted conduct.

The reason we are concerned with conflicted conduct is that it can lead to:

- high levels of replacement business, resulting in poor customer outcomes
- customers losing benefits or having claims denied that might have been accepted under their original policies.

Qualified Financial Entities (QFE) have different business distribution models; some employ their own advisers while others use intermediated advisers. We are concerned that the conflict of interest presented by QFEs manufacturing and selling insurance sets advisers up to fail in complying with their obligations. However, even QFEs that are not vertically integrated have a responsibility to ensure advisers are meeting their obligations to exercise care, diligence and skill and this, in our view, requires adequate management of conflicts of interest.

In our previous work, we focused on Authorised Financial Advisers (AFAs) and Registered Financial Advisers (RFAs) because they generally sell more than one brand of life insurance. This thematic review investigated how QFEs mitigate risks through their operational policies and procedures when selling replacement policies. QFEs are usually large financial organisations, such as banks, insurers and fund managers, that employ a variety of advisers to sell their products. There are approximately 21,500 QFE advisers operating in New Zealand.

We have stated in previous work that poor quality advice around insurance replacement business represents significant risks for consumers. A particular feature of insurance products is that consumers will not know that they have been mis-sold a policy until it is too late. They may not discover that their policy is not fit for purpose and does not cover their needs until they, or their families come to rely on that policy at claim time. This is the case whether the advice is provided by an RFA, an AFA or a QFE adviser

Insurance replacement business is a high-risk transaction. Potential harms include customers being over-insured or under-insured, and customers being sold a policy with less favourable terms such as exclusions or increased premiums which may affect their ability to claim on the policy at a later date.

This work is aligned with our Strategic Risk Outlook 2017 and our priorities to focus on the risks and harms associated with conflicted conduct across all financial services.

Our concerns about insurance replacement business and the harm it can cause are aligned with three of our seven strategic priorities:

- governance and culture
- conflicted conduct
- sales and advice.

This thematic review also addresses recommendations made by the International Monetary Fund (IMF) that we focus more on insurance conduct[3]. We did not include an assessment of incentives structures as part of this review. We are undertaking a separate thematic review of incentive structures in banks, to be completed by the end of 2018.

1: Based on the four types of life cover included in this review. For more comprehensive data, see the industry statistics collated by the Financial Services Council, which are available on its website.
2: Refer to our publications: 'Replacing life insurance – who benefits?', 'Raising the standards of life insurance advisers' and 'Conflicted Remuneration (soft commissions) in Life and Health Insurance'
3: International Monetary Fund, Financial System Stability Assessment, New Zealand, April 10 2017

What we looked at

This thematic review focused on QFE insurance providers' replacement business practices and assessed how their policies and procedures are designed to ensure consumer protection at the point of policy replacement.

We looked at QFEs' policies and procedures under the following four themes:

- how QFEs define replacement business
- how QFEs identify and monitor replacement business
- what controls QFEs use
- what actions QFEs take to remediate issues identified.

What we found

We explored whether the QFEs' processes were designed with good customer outcomes in mind. We have assessed this against our own specific QFE and replacement business guidance. We found significant discrepancies among the individual QFEs. Some have satisfactory processes in place while others still need considerable work. The other findings are:

- **Generally, there was insufficient acknowledgement that replacement business represents conduct and customer risks for businesses that need to be managed effectively.**
- **There is an inconsistent approach to how the industry defines replacement business.** While some providers define replacement business as one policy being replaced with a policy from a different provider, others include internal replacement or even define replacement business as a purely internal process regarding their own products. While an industry body states that a replacement policy is a policy changed with six months of discontinuing a current policy, this description is not agreed industry-wide.
- **The replacement business forms are used predominantly as a risk management tool for insurers.** The form is not used to support customers in their decision-making when they are recommended a replacement policy. In some cases, it is used as a disclaimer that no comparison has been made with a previous policy and the customer is asked to sign this, without explaining what the risks of changing the policy might be. Again, the approach from the industry is inconsistent in the format and content of the form and not designed with the customer in mind.
- **None of the QFE insurance providers reviewed have an independent process to distinguish between new and replacement business** (with one exception). Instead, they rely solely on their advisers to identify replacement business. If they are unable to measure what types of transactions are taking place, then they are unlikely to be able to manage the inherent risks of replacement business. This is compounded by the need to manage conflicts of interest, where volumes of sales may be driven by incentives.
- **A wide range of processes are used by QFEs to address the risks of insurance replacement**, with some more developed than others. We analyse this later in the report. A comparison of distribution methods showed that the processes used to oversee advisers selling a QFE's products are not necessarily always in line with our expectations.
- **Less than half of the entities advise customers that replacing their life insurance could lead to worse cover or the potential loss of benefits.** This casts considerable doubt on whether consumers have adequate information to allow them to reach an informed decision, especially taking into account the complexity of insurance replacement. Seven of the 11 entities specifically advise their staff that they expect them to prioritise the interests of their customers, or words to that effect. However, their sales practices for replacement business are not always consistent with this.
- **We are currently considering regulatory action in relation to a small number of QFEs, where the findings of this review suggest they may not be meeting their legal obligations.**

- **Despite these issues, we noted examples of where internal polices and processes were actively promoted to ensure that the advice and services were offered with positive customer outcomes in mind.**

Our expectations

In the past, we have set expectations around conduct, obligations and guidance on the topic of insurance replacement business. It is disappointing that despite the risks to consumers, some insurance providers do not identify insurance replacement as a particular area of risk. It is even more disappointing that QFEs do not appear to be taking sufficient steps to address these risks given we have been reviewing this activity since 2016.

QFEs must comply with legislation and standard conditions. Standard Condition 1.2 requires a QFE to maintain at all times 'procedures to ensure that retail clients receive adequate protection', while Standard Condition 1.3 requires the QFE to maintain procedures for monitoring this. Having adequate consumer protections for retail clients is also one of the eligibility criteria to be a QFE under section 66 of the Financial Advisers Act 2008 (FA Act).

We consider that adequate consumer protection requires that risks to retail clients are identified and managed. As such, we expect QFEs to manage their retail clients' risk through their policies and procedures when selling replacement policies, in complying with Standard Condition 1.2.

QFEs are responsible for any advice given by their advisers[4]. They must also ensure their advisers comply with their financial adviser obligations[5]. One of an adviser's obligations, under section 33 of the FA Act, is the obligation to exercise care, diligence and skill when providing a financial adviser service. We have issued guidance on the care, diligence and skill obligation, including in the context of insurance replacement advice[6]. We expect a QFE to meet its obligations and to have policies and procedures in place to ensure all its advisers comply with this obligation when providing financial advice.

We found that several QFE insurers do not have adequate procedures for replacement business. In order to raise industry standards and to ensure that there is no doubt about meeting their obligations, we recommend the following areas be addressed:

- QFE insurers should consider whether their current definition of replacement business provides adequate protection for consumers, with an acknowledgment that this is a high-risk transaction for customers. From this step we expect to see more consistent approaches to measuring and managing the risks of replacement business.
- QFE insurers should ensure they have considered the particular risks to consumers posed by replacement business. Their sales or advice processes should be designed to ensure that consumers understand the risks, as well as any benefits, of replacing their current insurance policy.
- QFE insurers should have effective internal processes to identify and track conduct associated with replacement business transactions. Such transactions should be identified from the point of view of consumer and conduct risk.
- QFEs must have systems and processes for replacement business sales and advice that provide adequate protection to retail clients. Several of the insurers we reviewed need to improve their processes and controls to meet the minimum legal standard.
- Multiple QFE insurers use their respective replacement business forms for their own benefit instead of achieving good customer outcomes. If the industry believes there is merit in using a replacement business form, then this needs to be consistently applied across the industry. They need to note in the form design what the outcomes are for customers.

4: Section 20F of the FA Act
5: Section 76 of the FA Act
6: https://fma.govt.nz/compliance/financial-advice/care-diligence-and-skill/

Introduction

Background

We have carried out substantial work on the conduct of Authorised Financial Advisers (AFAs) and Registered Financial Advisers (RFAs) in replacement business in the life insurance industry.

Following that work and the questions raised, this thematic review focused on QFE insurance providers' replacement business practices. The review sought to assess how QFE insurance providers' replacement business policies and procedures address the risks posed at the point of policy replacement.

In 2016 the IMF published a report after its Financial Sector Assessment Program (FSAP) mission visits. The report found that although conduct supervision has been enhanced through the fair-dealing provisions of the Financial Markets Conduct Act, there are still gaps in the framework for conduct regulation of insurance providers[7].

The Ministry of Business, Innovation and Employment (MBIE) recently published an issues paper for their review of insurance contracts law. The review is considering conduct regulation gaps in the insurance sector as identified by the IMF.

Why we conducted this review

Why life insurance

Our role is to promote fair, efficient and transparent financial markets. As part of this objective, we are interested in the outcomes for consumers when they receive insurance advice. There are various potentially adverse consequences from poor advice on life insurance. However, many of these may not be immediately visible but can have serious implications for consumers in the future. Because of the importance of insurance to the financial well-being of New Zealanders, we have previously published guidance on replacement business[8].

In this thematic review we focus on life, total permanent disablement/disability (TPD), trauma, and income protection insurance policies (relevant policies) because our earlier work has shown that these types of policies are replaced more often[9].

What are the risks associated with replacement business?

Unlike the majority of insurance advisers in New Zealand, most QFE advisers do not receive commission as a sole source of income and only sell products manufactured or supplied by the QFEs. However, there is obvious potential for conflicts of interest where advisers can only advise on their own firm's products. QFE advisers commonly have some form of sales incentive linked to sales targets. Despite these factors, we expect advisers to examine potential replacement business based on the circumstances for each customer.

This is particularly important because of the risks posed at the point of policy replacement. These risks include:

- consumers have claims denied that might have been accepted under original policies
- consumers lose benefits they might have otherwise received under original policies
- replacing policies purchased at a younger age may result in more expensive premium or limited benefits
- increased likelihood of exclusions or limitations associated with changes in health, lifestyle or occupation that have occurred since the original policy has been taken out
- inadvertent non-disclosure which reduces or annuls cover
- potential to reset any waiting periods for benefits
- policy benefits could attract a loading on a new policy that weren't subject to a loading on an existing policy, raising the long-term cost of the new policy
- consumers could be over-insured, or under-insured, because of poor advice.

We expect all QFEs to actively identify areas of potential client harm and put adequate procedures in place

7: https://fma.govt.nz/assets/Reports/170509-New-Zealand-FSAP-2016-FSSA.pdf (page 31)
8: https://fma.govt.nz/compliance/financial-advice/care-diligence-and-skill/
9: FMA, Replacing Life Insurance – who benefits? June 2016

to mitigate risks and meet their FA Act obligations to provide advice with care, diligence and skill. This is also true for insurance replacement business. We expect insurers to be able to differentiate between a genuinely new policy and replacement business.

Why we focused on QFEs

Typically, QFE advisers do not have to be individually registered or authorised. Their conduct is not governed by the Code of Professional Conduct for Authorised Financial Advisers. However, the QFE must at all times maintain procedures to ensure that retail clients receive adequate protection and effective processes to monitor these procedures. QFE advisers are the largest group of advisers in New Zealand.

Type	Approximate number	What they do	Obligations
Qualifying Financial Entities (QFEs)	53	Usually large organisations, such as banks, insurers and fund managers, that employ a variety of advisers to sell their products.	Granted QFE status by the FMA and must comply with various obligations to maintain their status.
QFE advisers	21,500	Employees or nominated representatives of QFEs (or any member of a QFE group). They sell the QFE's own products. They can give personalised advice on life insurance, but not as part of an investment planning service.	Not required to be individually registered, have to comply with QFE processes and general adviser obligations under the FA Act.
Registered financial advisers	7,000	Can give personalised advice on life insurance, but not on more complex products such as KiwiSaver, bonds, shares, managed investment products and derivatives.	Must register with the Registrar of Financial Service Providers - have to comply with general adviser obligations under the FA Act.
Authorised financial advisers	1,800	Provide personalised advice on most types of financial products. Can also be authorised to provide investment planning services.	Individually authorised by the FMA, required to abide by the Code of Professional Conduct for AFAs, including minimum education requirements.

For QFE advisers selling or providing advice on category 2 products[10, 11], the FA Act does not refer to any QFE-specific standards of competence or conduct (beyond the general obligations in the FA Act). Instead, the QFE has to explain in their Adviser Business Statement (ABS) how it sets standards for these advisers and maintains procedures to ensure adequate consumer protection. The QFE must ensure that its advisers exercise care, diligence and skill[12] and it must comply with all of its ongoing QFE obligations.

As outlined in our 'QFE Adviser Business Statement Guide'[13] we expect QFEs to have governance and compliance arrangements that ensure their processes help advisers consistently recommend or guide customers towards suitable products.

The standard of professionalism expected from QFE and non-QFE advisers doing similar work is the same, which is why we are interested in how QFEs ensure that they meet this standard. We have therefore included 11 QFE insurance providers[14] that provided relevant policies in New Zealand during the period of this thematic review (the entities).

What we reviewed

We began by analysing readily available information in the form of adviser business statements and regulatory returns submitted to us. We used this information to draft a questionnaire that we later discussed with all the entities and several industry bodies.

Based on the feedback received, we decided to focus on data for the period from 1 April 2015 to 31 March 2017 (the period) and provided the entities with a notice under section 25 of the Financial Markets Authority Act 2011 requiring them to provide us with information based on the questionnaire.

We analysed the data according to the themes identified on page two and all of our findings are based on this information.

In addition, we also used the complaints data we received and complaints information received from various Dispute Resolution Schemes (DRS) in our analysis.

Population

The primary focus of our review was on QFEs that manufacture[15] as well as distribute the relevant policies. While our sample provides an overview of QFEs of varying sizes, complexity and structure within the market, it also led to some inherent issues regarding comparability between the entities.

QFE insurance providers

- AMP Services (NZ) Limited
- ANZ Bank New Zealand Limited
- Asteron Life Limited
- Bank of New Zealand
- Cigna Life Insurance New Zealand Limited
- Farmers' Mutual Group
- Medical Assurance Society New Zealand Limited
- Partners Life Limited
- Sovereign Services Limited
- The New Zealand Automobile Association Inc.
- Westpac New Zealand Limited

Our sample population ranges from small insurers with less than 50,000 clients and 92 advisers to larger insurers with in excess of 2 million[16] clients and 4,500 advisers.

10: For the distinction between category 1 and category 2 products, refer to: https://fma.govt.nz/assets/Guidance/category-1-and-category-2-product-definition-guide.pdf
11: Most of the insurance policies covered in this thematic review are category 2 products.
12: See section 76 and section 33 of the Financial Advisers Act 2008
13: https://fma.govt.nz/assets/Guidance/100901-qfe-adviser-business-statement-guide.pdf
14: The number of insurers as per our definition as of October 2017
15: Most entities were registered insurers licensed by the Reserve Bank of New Zealand
16: As per the RBNZ insurer register, all of these numbers relate to total available retail customers through the parent company, not only life insurance customers.

In order to address insurance replacement business in its entirety, we reviewed all of the entities' distribution methods. This allowed us to make comparisons based on consistent themes and we observed that six out of the 11 entities have more than one distribution method.

Depending on the structure of the business, an entity may use one or a combination of these various distribution methods:

Type	Internal – staff employed directly by the QFE	External – persons under an arrangement (not directly employed) to distribute the QFE's products
Contact Centre	✓	✓
RFA	✓	✓
AFA	✓	✓
Nominated Representatives[17]		✓
QFE Advisers	✓	

Some of the differences in policies and procedures encountered in our analysis may be due to the differences in the entities' distribution methods or size of the respective business.

A large number of insurance policies are sold through vertically integrated firms. We found that most QFEs are (at least partially) vertically integrated. These firms both manufacture insurance products and are responsible for overseeing the conduct of their advisers. This creates an inherent conflict of interest that needs to be managed. While all insurers must, for their part, take responsibility for conflicted conduct that results from the incentives or sales targets they created, the greatest onus is placed on vertically integrated firms. Due to the fact that they manufacture and sell their own products, they face greater challenges of managing the conflicts of interest inherent in their business models.

17: As per section 74 of the FA Act (A QFE can nominate any individual adviser as a nominated representative. A person may not be a nominated representative of more than one QFE, except when the two QFEs are related companies, as this would cause confusion about which entity was responsible for the representative's conduct. A QFE is responsible for ensuring compliance by each nominated representative with the terms and conditions of the grant of status and is further responsible for ensuring compliance with each nominated representative's financial adviser obligations).

What we found

In this section, we outline what we learned about how the QFEs address their obligation to 'maintain procedures to ensure that retail clients of the QFE receive adequate consumer protection'[18] at the time of policy replacement.

We looked at QFEs policies and procedures under the following four themes:

- how QFEs define replacement business
- how QFEs identify and monitor replacement business
- what controls QFEs use
- what actions QFEs take when issues are identified.

Insurance replacement business definition

As the basis of our analysis, we sought confirmation from each entity as to whether they agreed with the following definition of replacement business as provided by the Financial Services Council (FSC):

> *"all situations where a new policy is issued within six (6) months of another policy being discontinued and the life insured (or one of the lives insured) is the same"*

Nearly every entity has a different definition. We observed that of the 11 entities, only four take into consideration the time periods between a discontinued policy and subsequent replacement policy when defining replacement business.

We discovered that policies that have recently been discontinued, for instance because premiums have not been paid, can often be re-instated simply upon request. We consider that similar advice processes that apply to replacement business should also be used in these circumstances, to ensure the policy is still meeting the customer's needs.

We are most concerned that when a replacement policy is being recommended the customer needs to be aware of the adverse consequences of moving from one policy to another.

We also noted that one entity does not define the practice as 'replacement business' unless the original policy is from within their group. Based on this definition, it appears that the entity is only monitoring replacement business to protect its revenue and not to protect their customers from potential risk. In addition, this indicates that they have no oversight in place for replacement policies between other insurance providers.

Identifying and monitoring replacement business

Identification

Our expectations

In order to meet their obligations under the FA Act, we expect all QFEs to actively identify areas of potential client harm and put adequate procedures in place to mitigate these risks.

For the reasons already outlined there are specific risks associated with replacement insurance advice. We expect insurers to be able to differentiate between a genuinely new policy and replacement business. These two situations require a different approach to how advice should be structured and offered, and therefore a needs-analysis or questionnaire that identifies any existing policies should precede any advice.

Our findings

A total of nine entities record replacement business in their systems. Despite different methods of identification (as part of a needs analysis, through application or replacement business forms, process tick-boxes etc.) all

18: Section 66 (1)(c)(iii) of the Financial Advisers Act 2008 (FA Act) entities, except one, rely solely on their advisers to make the identification for them.

We are concerned that the absence of clear direction and formal decision-making rules around identifying different types of sales and advice processes make it harder for advisers and QFEs to effectively manage potential conflicts of interest. We think that appropriate performance measures for front-line staff, paired with sampling of replacement identification, would help make the process more robust. Without reliable identification there is a risk of insurers not knowing whether an application is genuinely new or constitutes replacement business.

We found the majority of entities do not assess whether a policy replacement is actually achieving good customer outcomes. Instead, they rely on their advisers to make an adequate customer recommendation despite the inherent conflict of interest for both the adviser and QFE. The only exceptions we have seen are two entities that rely on an external comparison tool for comparisons between policies, which the adviser presents to the customer.

Good practice

We found only one entity that does not solely rely on information provided by their advisers to identify replacement business. Instead, they draw information from an internal tracking system. If a policy is not part of this system it is automatically flagged for review under the entity's internal quality assurance process.

Poor practice

One entity identifies replacement business by asking their customers whether they hold any other life insurance policies as part of the application process. However, this is not done in order to warn the customer about potential risk but to prevent the entity from offering combined cover in excess of $1 million for each life insured. While it is considered standard in the industry to avoid unknowingly exceeding $1 million for each life insured, it is essential that the customer should be made aware of the risks of replacement business.

Poor practice

One entity only identifies and tracks internal replacement business. Therefore, replacement business between other insurers is neither captured nor identified. Without even a basic mechanism of identification, there is no way of providing their customers with good advice or mitigating the inherent risks of replacement business.

It is difficult to see in this example how the QFE is protecting the consumer from the harms of poor quality advice or a poor outcome from replacing their insurance policy.

Processes

Our expectations

We expect QFEs' processes to achieve two outcomes:

- to ensure that their customers are given adequate advice
- to monitor adviser conduct to identify any issues or patterns that create conduct risk.

Quality advice to customers allows them to make informed decisions. In the area of replacement business, we expect the client to be informed about the risk areas outlined earlier in this report.

Given that QFEs are responsible for the advice provided by their QFE advisers, we also expect they have adequate oversight to ensure these points are properly communicated to their customers. Advisers who fail to meet the required standards should be identified and subject to an appropriate action. We have already noted to this sector that a lack of formal observation processes[19] is a cause for concern and improvement.

Our findings

Among the 11 entities reviewed, less than half advise their customers that replacing their life insurance could lead to worse cover or the potential loss of benefits. This means consumers are not being provided sufficient and necessary information to make an informed decision on the benefits and risks of the advice that is being offered. This concern is exacerbated with the potential complexity of insurance replacement and the variety of different policies available.

A higher percentage (eight out of 11) of the entities inform their customers about the more straightforward facts that replacement business could lead to a difference in premium, and that they should not cancel their original policy until the new one has been put in place.

Based on the information received, only seven out of 11 QFEs specifically train and tell their staff that they expect them to achieve positive customer outcomes.

Overall we found that seven of the 11 entities could improve their processes. In a number of cases, the entities' processes were totally unsatisfactory.

While making this assessment we took into account the variety and complexity of providers and their different business models, judging whether the process was fit for purpose. Despite some notable exceptions, we found the majority of QFE insurers have either minimal or only nominal controls in place with regard to replacement business.

Good practice

One entity actively tracks replacement business via an internal tracking system and rates advisers as part of their quality assurance programme. Regular file reviews take place with priority given to higher risk areas, such as replacement business. In addition, regular internal monitoring visits are undertaken with detailed feedback provided to individual advisers. An internal incident management system ensures that action plans for non-compliant advisers are implemented and an additional vetting system ensures quality of advice.

Good practice

One entity asks advisers to complete an Advice of Replacement Business form which is then submitted to the regional manager for approval. All replacement business is recorded and presented to a governance committee on a monthly basis. In addition, the entity conducts a quarterly review of three client files per adviser, proactively ensuring high quality advice.

19: https://fma.govt.nz/assets/Reports/140912-qualifying-financial-entities-monitoring-report-2014.pdf

Poor practice

We found weak oversight in just under half the QFEs we reviewed. The findings below are from five separate entities:

- One entity has no process in place when it comes to replacement business. They ask their staff not to facilitate or manage the replacement of life policies but there are no controls in place to ensure that this actually happens. Ultimately, no advice is provided and the customer carries full responsibility to determine whether the entity's policy meets their needs.
- One entity has no oversight process in place and simply cautions their customer about potential risks without further elaborating on them.
- One entity has only one particular team that is allowed to process replacement business. These advisers are encouraged to prepare one sentence where they describe differences between policies; besides this they rely heavily on scripted generic talking points.
- One entity has no oversight process but instead relies on underwriters to identify replacement business. Since a customer decision has already been made at this point, we consider this, at best, an indicator of replacement after the fact. The entity also looks at adviser persistency ratios, which we consider to occur in the entity's interest rather than to protect customers.
- One entity does not provide personalised advice as part of their QFE distribution method but relies on class advice. As part of the 'welcome' documentation, the customer is provided with a generic message, prompting them to compare their new policy with their old one in case of replacement. The comparison is reduced to two factors: the amount of cover and premium cost. This supposed warning message is not provided at any time earlier in the process when helping the customer in the decision making. The only oversight that the entity maintains is a quality assurance process that focuses purely on QFE adviser competency.

Differences among distribution methods

We wanted to understand what difference, if any, exists among different distribution methods as QFEs are responsible for their QFE advisers and for any procedures in place to ensure retail clients are protected.

We therefore had a closer look at the six entities that have more than one distribution method (as outlined in Section 1) and how their processes differ among distribution methods.

Of these six entities, three demonstrated more robust processes for their QFE distribution method, going some way to meet our expectation in principle. There is still room for improvement for some of these entities.

The other three entities demonstrated QFE processes that were either equal to or weaker than the ones displayed in their other distribution methods.

- One entity makes no distinction between the different distribution methods in monitoring/oversight and instead relies on adherence to internal systems and resources. Their focus is on ensuring that advisers know what they are doing through training and coaching, regardless of the distribution method. There is no oversight process in place for either of the separate distribution methods, and the entity relies on customer complaints to outline deficiencies in their process.
- One entity provides only class advice in their QFE distribution method. They do not provide their customers with advice about the risk of replacement business, instead comparing only cover and premium. The only oversight process in place focuses on QFE adviser competency with no visibility of the actual advice provided to customers. As part of their AFA distribution method the customer receives a comprehensive comparison between policies. Each AFA is, however, responsible for the comparison they provide with only minimal oversight in place.
- For one entity, quality assurance in the class advice distribution method only takes place if the insurance is lending related and involves reviewing meeting notes. The focus is on whether a risk conversation took place, but there are no specific checks to assess the quality of the insurance conversations. Apart from this, the entity appears to rely on an initial QFE accreditation process, training and oversight carried out by the QFE advisers' managers. As part of the AFA distribution method, a regular file review takes place, with an explicit focus on whether the replacement advice was justified, and whether the customer has signed the replacement form. When the insurance is lending-related, there are additional checks similar to the ones carried out as part of the QFE distribution method.

What controls QFEs use

Our expectations

In order to understand what controls the QFEs had in place we requested a copy of the replacement business form, or if this did not exist, a description of any alternatives used. Although there is no obligation to specifically use a form we expect QFEs to have adequate controls in place to address the key issues and risks posed at the point of policy replacement.

As outlined in our guidance on care, diligence and skill[20] published on our website, when it comes to insurance replacement we consider a comparison between policies to be good practice. While we consider the actual advice provided to customers is paramount, we recognise the value of using replacement business forms if they inform the customer of the possible risks involved, and if they initiate a discussion about whether replacing an insurance policy really achieves good customer outcomes. An example of a replacement form can be found on the website of the Financial Services Council (FSC)[21].

20 https://fma.govt.nz/compliance/financial-advice/care-diligence-and-skill/
21 https://www.fsc.org.nz/site/fsc/files/Replacement%20Policy%20Advice%20May%2013/FSC_RPA%20form-1.05.13.pdf

Our findings

A total of seven QFEs use replacement business forms in their processes and each of them require the customer to sign the form before the new policy is put in place. Usually the replacement business form is used very late in the process, which in our opinion reduces the value of the form as an aid to the decision-making process. We observed that many replacement business forms are used as a tool to mitigate risks and as disclaimers that the adviser has not given any comparison with the previous product, and the customer accepts this by signing.

As mentioned in our March 2018 report, FMA update on enquiries into insurance replacement business[22], several RFAs informed their customers only about the new product and failed to advise customers about the potential adverse consequences of replacing their policies. Nor did these advisers have any records to demonstrate the service they provided or how they communicated with clients, resulting in warnings for four advisers. It is important that customers understand any conflicts of interest and whether the information on the replacement business form has been taken into account during the advice process.

One entity emphasised that the customer should rely on the Statement of Advice for a summary of risks and benefits. Instead, they propose an alternative use for replacement forms. If replacement forms were presented to the incumbent insurer prior to the new policy being written, it would give the opportunity to present the customer with options.

This suggestion could mitigate some risk of replacing an existing policy and meet newly identified needs (such as adjusting premiums, removing/reducing loadings, etc.). It could help manage poor outcomes for customers.

Good practice

One entity does not have a replacement business form but instead conducts a comprehensive comparison between the original and proposed policies, identifying gains and losses related to replacing cover. Categories compared include benefit periods, wait periods, sums assured, premium structures, differences in covered medical conditions and overall benefits.

Poor practice

One entity feels that since their QFE advisers sell products online or over the phone, there is no need for a replacement business form. It is unclear whether replacement is addressed as part of this distribution method. For their external financial adviser network, they use replacement business forms that appear to be purely geared towards calculating commission payments. The form still needs to be signed by the entity's customers since they have to commit to cancelling their original policy once the new one has come into effect. There is no evidence of the entity cautioning the customer about potential adverse outcomes of replacing their policy.

22: https://fma.govt.nz/news-and-resources/reports-and-papers/life-insurance-replacement-business

Poor practice

One entity does not use a replacement business form but instead relies on staff using internal systems for scripting and printouts to provide to the customer. While their procedure document includes generic warnings regarding replacement business, it fails to go into detail and there is no control in place to ensure that these details are actually shared with the customer as part of the advice process.

The application form includes a short section on potential 'advantages and disadvantages' before asking the customer to sign 'You confirmed you had considered the risks and wished to proceed with the cancellation of your existing policy.'

What actions do QFEs take when issues are identified?

Our expectations

We expect QFEs to take action whenever their oversight and monitoring identifies issues or problems in their replacement business. This may relate to the replacement business processes or to the conduct of individual advisers. Given the risks associated with insurance replacement business, we expect such conduct to be tracked on an adviser level and appropriately addressed in case of shortcomings. Each QFE should have suitable tools at its disposal to ensure high-quality advice is given to its customers.

Our findings

The QFEs outlined a broad range of possible actions they can take when they identify issues or problems with replacement business. Most actions involve investigations, interviews with the adviser involved, coaching or additional training, and on the far end of the scale, disciplinary action and employment termination. A total of six out of the 11 entities also indicated that they tell their customers about these actions, where appropriate, and remedy any adverse customer outcomes.

During the period, six entities identified a total of 403 instances where action had been taken based on insurance replacement business. A total of 67% of these represent administrative errors related to replacement business and the remainder relate to actual adviser conduct issues. Overall, the actions appear to be appropriate given the issues identified, with the exception of one entity's example outlined below.

Good practice

One entity conducted a total of 350 instances of quality assurance over the period with a focus on more high-risk advice such as replacement business. Together with an internal thematic review and a notification by another adviser, this brings the total number of identified issues related to replacement business to 33. Examples of actions include termination, remedial steps, replacement business vetting, prohibition of execution only, additional training, supervision/monitoring and guidance.

Poor practice

While one entity has a wide range of actions available to them, they appear to rely exclusively on training and customer remediation for minor issues like insufficient documentation (31 cases) and various Statement of Advice issues (56 cases). The same actions are taken in cases of seemingly severe misconduct such as replacement without customer consent (two instances), wilfully omitting medical issues on the application form (one instance), specific downsides of replacement not communicated to customer (four instances) or insufficient comparison between policies (two instances).

Poor practice

One entity's oversight and monitoring process is designed to provide 'holistic monitoring' of lending-related insurance, therefore there is no process in place to pick up issues arising from replacement business.

Our expectations

Concerns that need to be addressed

We have previously set expectations around conduct, obligations and guidance on the topic of insurance replacement business. It is disappointing that despite the concerns we have raised and the risks to consumers, some QFE insurance providers have not listened and do not identify insurance replacement as a particular area of risk.

We want to see improvements in the practice of replacement business in the life insurance industry. While this thematic review is focused on QFE insurance providers, we also encourage all other insurance providers and advisers to take note of this report. They must ensure that they have proper controls to prevent poor outcomes and processes to promote good customer outcomes.

As part of our review, we have seen many approaches, mainly due to different business models. Despite these differences, there are clearly some good approaches and some less suitable ones.

To raise industry standards, we recommend these areas be addressed.

- QFE insurers should consider whether their current definition of replacement business provides adequate protection for consumers with an acknowledgment that this is a high-risk transaction for customers. From this step we expect to see more consistent approaches to measuring and managing the risks of replacement business.
- QFE Insurers should ensure they have considered the particular risks to consumers posed by replacement business. Their sales or advice processes must be designed so that consumers understand the risks, as well as any benefits, of replacing their current insurance policy.
- QFE Insurers should have effective internal processes to identify and track conduct associated with replacement business transactions, identifying such transactions from the point of view of consumer and conduct risk.
- QFEs must have systems and processes for replacement business sales and advice that provide adequate protection to retail clients. Several of the insurers we reviewed need to improve their processes and controls to meet the minimum legal standard.
- Multiple QFE insurers use their respective replacement business forms for their own benefit instead of achieving good customer outcomes. If the industry believes there is merit in using a replacement business form, then this needs to be consistently applied across the industry, and include in the form design the outcomes customers should achieve.

Next steps

We are currently considering regulatory action in relation to a small number of QFEs, where the findings of this review suggest they may not be meeting their legal obligations. We will be providing all QFE insurers with feedback from this report so they know that we expect their policies and processes for replacement business must be in line with good customer outcomes.

Where we have issues with QFEs meeting their obligations then we will be working with them to ensure that they improve their processes and controls to provide adequate protection to retail clients.

We will continue to use our regulatory tools to monitor conduct, sales and advice practices and commission structures in QFE insurance providers.

We are also scoping further reviews in the insurance sector. We are concerned that the conflict of interest presented by QFEs manufacturing and selling insurance sets advisers up to fail in complying with their obligations. Even if most QFE advisers do not receive commissions, they are incentivised through key performance indicators or sales targets, which ultimately leads to similar outcomes for the customer. We strongly encourage all insurers to ensure their consumer protection practices are robust in this area. We have started a thematic review of incentives structures in large firms, due to be completed by the end of 2018.

Future changes to the insurance sector in New Zealand

The Financial Services Legislation Amendment Bill (FSLAB) is currently going through the select committee. This legislation will ensure all advisers and advice firms have a clear set of expectations and controls around conflicts. It includes the requirement to give priority to the client's interests and will be subject to a new Code of Conduct. This Code of Conduct will set minimum standards of competence, knowledge and skill, ethical behaviour, and client care.

The Ministry of Business, Innovation and Employment (MBIE) has recently published a terms of reference for a review of insurance contracts law.

Glossary

Adviser	Provides financial advice to consumers. Includes AFAs, RFAs and QFE Advisers.
AFA	Authorised Financial Adviser – an individual financial adviser authorised by the FMA to provide personalised advice on most types of financial products, including insurance. Can also be licensed to provide investment planning services.
FA Act	Financial Advisers Act 2008.
FMA Act	Financial Markets Authority Act 2011.
IMF	International Monetary Fund - an international organisation which works to secure financial stability, facilitate international trade and promote high employment and sustainable economic growth.
QFE	Qualifying Financial Entity – a business that takes responsibility for the financial advice provided by its employees and nominated representatives, without those people having to register as advisers individually.
QFE Advisers	Employees or nominated representatives of QFEs (or any member of a QFE group). They sell the QFE's own products. They can give personalised advice on life insurance, but not as part of an investment planning service.
Replacement business form	A form meant to help a consumer decide whether an existing policy should be replaced. It should clearly list potential advantages and disadvantages of replacing a policy and serve as a basis for discussion and decision-making. Advisers are not required by law to use this form but many in the industry see it as good practice.
RFA	Registered Financial Adviser - an individual financial adviser who is registered on the Financial Service Providers Register but who is not authorised by the FMA. Can give personalised advice on most insurance products including life and health insurance. They are not permitted to give advice on more complex products such as KiwiSaver, bonds, shares, managed funds and derivatives.
Vertically integrated firm	Where the manufacturing element and sales element of products sit within the same entity, or group of entities; or where one company owns every part of the supply chain.

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