Deep Fried Bananas

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You can buy one of those bananas with the red wax tip at your local supermarket for less than a dollar.

The red wax tip lets you know the banana is grown organically. The epitome of wholesome, natural goodness. No artificial additives, preservatives, flavours, colours, herbicides, or pesticides - all the "goodies" we usually need to keep the food chain lubricated.

Even vegans eat them.

However, if one of those bastions of wholesome, natural goodness finds its way into a takeaway shop, where Pauline (an underpaid, spotty school kid)

- peels it
- dunks it in batter
- throws it into a basket, along with a scoop of chips, a few of bits of fish and a doughnut
- deep fries it in saturated animal fat that hasn't been changed since the Vietnam war
- rolls it out of the basket onto a bed of castor sugar
- wraps it in a napkin

it is transformed into a $5 culinary abomination.

You pass this takeaway store late at night, after a bit of a bender, and you might even part with $8.

The owner of the takeaway store is probably into the banana fritter, what with raw materials, machinery, and labour, for less than two bucks.

What this means, is that something that costs less than $2 to produce, can be on-sold with a mark-up of between 60% to 75% of the final sale price.

What this also means, is that something that started life with the Heart Foundation tick, has been turned into something that would most likely make the Heart Foundation very cross.

But there is no law against it. No food regulator to shake their metronomic index finger at Pauline's boss …

… and this brings me round nicely to the subject of Add-On Insurance.

How could Add-On Insurance ever be a good thing?

After all, it is sold at car yards by men with too much aftershave and teeth coated in correction fluid.

But even after numerous ASIC reports, a Royal Commission of Inquiry, the ongoing condemnation of the Consumer Action Law Centre and some major legislative changes, Add-On Insurance, apparently, lives on.

ABSTRACT

This paper looks at the thorny issue of Add-On Insurance sold at car yards, examines and provides insights into the key historical behaviours and outcomes that gave Add-On Insurance its poor reputation, the various regulatory actions and reforms, and asks whether this market can be transformed into one that offers good quality products, at reasonable prices, that meet identifiable consumer needs.

Key Words: Add-on insurance, junk insurance, car dealers, extended warranty, ASIC, bananas!

A guide to what is ahead in this paper

There are five main sections to this largely, non-technical paper

1. History and background to add-on insurance in three approximate time periods
    - Up until 2016 - a summary of the various "sins" committed
    - 2017 through 2019 - what ASIC and other investigations found
    - 2020 until now - the "fixes" (i.e., reform)
2. Reform furphies - well intended reforms that may well have unintended (and unfavourable) consequences for consumers, as well as insurers
3. Busting a few myths associated with specific add-on insurance products - mostly these myths exist because of widespread lack of knowledge and understanding of the many variations of products, their issuers, and who they are (or are not) regulated by. This section aims to fill in that knowledge and understanding gap.
4. The "flush out" of add-on insurers who don't start selling good quality add-on products
5. Wrap Up

The reader should also be aware that the add-on product issues that have become quite well known through the media, the Hayne Royal Commission and various ASIC reports, are actually "connected" to many other areas of enquiry, including the recent Senate Committee Inquiry into franchising agreements between automotive Original Equipment Manufacturers (OEMs) and their franchised dealers.

It has not been possible for me to explore all of these inter-connections in full; rather I have hinted reasonably strongly at the major themes with these inter-connections, and I leave it to the reader to explore those further, as they see fit.

One of my hopes, in reading this paper, is that you will start to see that the problems with add-on insurance are merely symptoms of larger issues that spread far outside of the insurance and finance sector, and hence beyond the reach of regulation that is focused just on finance and insurance.

I do not profess to have all the answers to the many issues that have arisen with add-on insurance, but I do hope that readers come to see that often things are nowhere near as clear cut as they might seem at first glance.

1. A brief(-ish) history of add-on insurance

1.1 Up to about 2016

For well over 15 years, general insurance companies sold add-on insurance products through car dealerships and other distributors, latterly under the General Advice provisions of the Corporations Act (2001).

Car dealerships and other distributors acted as Authorised Representatives of the add-on insurer.

Add-on insurance products sold through car dealerships include

- Extended Warranties and variations thereof
- Guaranteed Asset Protection (GAP) and variations thereof
- Consumer Credit Insurance (CCI) and variations thereof
- Tyre & Wheel Insurance

A short description of these products is provided in Appendix A.

Like all general insurance products, add-on products were (and still are) exempt from the conflicted remuneration provisions under the Corporations Act and, until very recently, no formal guidelines were provided by the regulator, the Australian Securities and Investment Commission (ASIC), around what levels of commission and other incentives payable to dealerships were reasonable (let alone legal).

Conflicted Remuneration

"Conflicted remuneration" simply means that the seller or distributor is being remunerated for making the sale in a manner which potentially incentivises them to act in their own best interest rather than in the best interest of the consumer who is purchasing the product.

An example would be where a distributor has two alternative products to offer a consumer. The products are identical in terms of the benefits they offer the consumer but the prices of these two products are not

- Product A pays the distributor 20% of a $1,250 premium in commission (i.e., $250)
- Product B pays the distributor 50% of a $2,000 premium in commission (i.e., $1,000)

Notably, the premium net of commission is the same in both cases (i.e., $1,000).

In general, any time the distributor sells Product B, it would be difficult to argue that they acted in the consumer's best interest and not their own.

However, there does not necessarily need to be a "Product B" for there to be a potential or actual conflict of interest.

Product A still provides the distributor with a $250 incentive to be sold - a clear conflict, if the best interests of the consumer would be met by not selling them anything at all.

No "speed limit" on commissions

However, with the exception of Consumer Credit Insurance (CCI) products, which are also covered under the National Consumer Credit Protection (NCCP) Act (2009), there was (and is) no "speed limit" on commissions (e.g., the 20% commission cap that applies to all CCI products sold under NCCP legislation).

Consequently, as "speeding" in the add-on sector was not strictly illegal, distributors and insurers did not feel compelled to sell consumers add-on insurance products with modest or reasonable commissions.

Typical commission levels included in premiums for Extended Warranty, Tyre & Wheel and GAP products were north of 50% and, in extreme cases, as high as 80%.

It is worthwhile to consider just how leveraged premiums are to these different commission levels (as well as to view how the commission rate is expressed and calculated).

Taking our "Product A" and "Product B" from above, at a premium of $1,000 plus commission (excluding government charges) note that

- At 20% commission, the full premium is (as above) = $1,250
- At 50% commission, the full premium is (as above) = $2,000
- At 80% commission, the full premium is (miles above) = $5,000

Using these examples, it is relatively easy to see how the very low loss ratios noted in ASIC's various reports issued in 2016 were generated[1].

If the expected claim cost (i.e., a simple measure of the "return" or "value" provided to consumers) was $400 then

- At 20% commission, the expected loss ratio is 32%
- At 50% commission, the expected loss ratio is 20%
- At 80% commission, the expected loss ratio is 8%

Undoubtedly, the loss ratio outcomes at 50% commission or higher would not pass the proverbial "pub test".

Even the 32% loss ratio would be considered marginal by some.

All the above premiums provide the insurer with a 40% loss ratio on premium net of commission and so, *prima facie*, should be profitable, provided the insurer's expenses are well managed.

Other incentives

However, the incentive payments to car dealerships and other distributors did not necessarily stop at transactional commissions. There were often "volume bonus" payments for especially high sales volumes but also two further types of payments that, in many ways, were dressed

[1] https://sitesearch.asic.gov.au/s/search.html?query=REP+470&collection=asic&profile=asic
https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-492-a-market-that-is-failing-consumers-the-sale-of-add-on-insurance-through-car-dealers/

up to sound innocuous enough but, in substance, they were either largely, or purely, incentive payments (and therefore incremental to the conflict).

These are

- "Introducer Fees"
- "Marketing Assistance Payments"

These names are intended to be generic descriptors. Many other names for essentially the same type of payment did (and in some cases probably still do) exist.

Introducer Fees

An "Introducer Fee" can be either a percentage of premium (like commission) or a fixed dollar payment, paid to the distributor when they sell an add-on insurance policy, ostensibly in lieu of their marketing and distribution expenses.

If the Introducer Fee in the above examples is $450 then the insurer's premium net of commission and Introducer Fee is now only $1,000 - $450 = $550 and the insurer's loss ratio on premium net of all acquisition costs rises to $400/$550 = 73%. At this loss ratio, insurer profitability is not assured.

Marketing Assistance Payments

"Marketing Assistance Payments" were typically a fixed (and often substantial) lump sum payable to the distributor in advance of actually selling any products.

Subsequently, a Marketing Assistance Payment (MAP) contract would be drawn up between the distributor and the insurer, agreeing on a mix and volume of add-on business to be sold in a given timeframe (e.g., the next 3 years).

In theory, it would have been illegal to include any CCI product in the calculations, as the maximum allowable incentive payment on a CCI policy is 20% of the CCI premium[2] and that 20% limit would have more than likely already been exhausted by transactional commission payments.

The purpose of the MAP contract (to accompany the advance payment) was to increase the chances the insurer could at least cover their fixed expenses, as these large upfront payments were effectively funded out of future insurer margin.

However, add-on insurers often struck problems with MAPs as some distributors

- failed to meet contractually agreed sales targets (often because the sales targets were inflated to unrealistic levels by insurers to drive out a larger MAP to attract the business in the first place)
- went out of business (i.e., became insolvent) before they had reached the minimum mix/volume target
- simply felt no great urge to respond to the contract, as insurers were known to be reluctant to pursue the distributor in the courts, as news would spread around the motor industry that the insurer was taking such legal action and consequently other distributors would not be so keen to do business with that insurer

In some cases, the total incentive remuneration paid to the distributor (i.e., commissions, volume bonus, MAPs and/or Introducer Fees) led to a situation where the arrangements with that distributor were nowhere near profitable for the insurer when the **actual** (not the projected) business mix and volume began to be realised (although they were almost certainly profitable for the distributor).

[2] excluding GST and Stamp Duty

It is not completely unfair to say that, for a time, "sales skill" was largely redundant and that the ability to write large cheques for MAPs defined the success (or otherwise) of some add-on insurers' sales teams.

Furthermore, many industry insiders also came to believe that, if a salesperson had become too accustomed to large MAP cheques being the primary driver of add-on insurance sales, then they never really got their "sales mojo" back after MAPs were eventually banned by ASIC.

MAPs may also continue to give legacy add-on insurers grief for some time due to their accounting treatment. MAPs were, in some cases, recorded initially as an intangible asset in the Balance Sheet, at the amount paid in advance to the distributor.

As business was written under the MAP contract, a pro rata amount of the MAP intangible was transferred to Deferred Acquisition Costs (DAC) to begin the amortisation process, in line with premium earn out. With many of the MAP contracts running for at least 3 years (and many with options to extend the term), these "assets" could remain on some add-on insurers' Balance Sheets for a few more years yet, despite being banned (and grandfathered) from late 2016.

As noted above, with many of the sales targets often being inflated unrealistically, the value of the MAP intangible was often questionable, and I suspect MAP intangible asset impairment will be an ongoing theme for some add-on insurers (or until they take the decision to write the remaining MAP intangible asset off totally).

Consequences of excessive incentives

With such a high proportion of a now excessive add-on insurance premium available to a dealership as incentives there came some particularly unsavoury conduct.

The worst examples were just outright mis-selling of products

- telling consumers that the purchase of the add-on product (e.g., GAP and/or CCI) was a condition of getting finance
- selling a CCI product with unemployment cover to the unemployed and/or casually employed (who would never be able to claim)
- selling products with no value to the consumer – e.g., a GAP policy to a consumer with a large deposit
- selling a GAP product with up to $30k of cover to a consumer with a $10k auto loan

and all of this presented using pressure selling tactics to confused and naive consumers, at the end of a long day at the dealership, where they thought they had only come to buy a vehicle.

How did it get to this?

It is easy to demonise insurers and distributors, and undoubtedly their conduct, while not necessarily illegal, was unlikely to pass any kind of "pub test".

But things are rarely that simple.

Insurers

I do not believe add-on insurers deliberately set out to fleece their policyholders.

Add-on insurers were like any business. They had products that they wanted to sell in an attempt to make a profit.

Distributors (e.g., car dealers) maintained strong "ownership" over access by insurers to their customers. Add-on insurers did business with their policyholders via the dealerships. Dealerships leveraged the ownership of that relationship with consumers and demanded higher levels of commission and other incentives from insurers if they wanted their products to be sold by those dealerships.

If an add-on insurer wanted to be "Gavin-Good-Guy Pty", and only pay modest commissions, they simply did not get to write any business.

For some dealerships, a large and possibly recurring MAP was also necessary.

In this way, add-on insurers fell into something of a downward spiral of paying ever higher commissions and other incentives (as described above) just to maintain access to their policyholder base.

But it wasn't just the high levels of commission and other incentives that caused problems for add-on insurers.

Community rating

Most add-on insurance products also had very little risk rating.

In other words, in many cases, "good" risks provided cross-subsidisation of "bad" risks.

Common examples would be

- consumers purchasing an extended warranty on a small, basic FWD Japanese vehicle with 40,000 kms on the odometer paying the same or similar premium as consumers purchasing a larger, higher performance and/or 4WD vehicle, manufactured in Australia, with 95,000 kms on the odometer
- Someone borrowing 80% of the vehicle purchase price being charged the same GAP premium as someone borrowing 120% of the purchase price of the same vehicle, over the same term, at the same interest rate
- A 35-year-old policyholder with a solid employment record being charged the same CCI premium as a 60-year-old policyholder whose employment record was patchy
- The purchaser of a Tyre & Wheel policy for a vehicle with small, higher profile tyres and cheap rims being charged the same premium as a vehicle with large, low profile tyres on expensive rims

In my opinion, the lack of significant risk rating compounded the issues of high incentive payments and meant that many "good" risks got low, if not zero, value from some add-on products.

Risk rating was another area where insurers struggled to get buy-in from distributors.

Risk rating means that consumers automatically get charged a premium proportional to their risk.

However, many distributors just liked knowing that when they sold a [GAP] policy, they were going to charge [$1,195] for it (including Stamp Duty and GST) and pocket around [$500] in commission.

Distributors would also have had to do more training to explain the more complex pricing approach to their customers (which of course they were already doing every day in relation to comprehensive motor insurance) and so, as was the case with trying to lower commissions, distributors generally just rejected attempts by insurers to increase the complexity of the premium rating basis because it made the job of selling products more time consuming and difficult (and conveniently used IT systems limitations as an excuse).

In summary then, many distributors effectively demanded high levels of incentive payments and simple, community-rated products, and any insurer who was not prepared to comply with those requirements simply did not do business with those distributors.

This situation is referred to by some as "reverse competition"; the product that represents the *worst* value for money to consumers is the one most likely to be sold.

When you have either entire insurance companies, or large departments within larger insurers, set up to focus solely on selling add-on insurance products through car dealerships (or similar), that is a lot of peoples' jobs (or an entire business) that would suddenly be in grave danger if the insurer took the decision to "do the right thing".

Ironically, in the absence of regulatory intervention, it would have effectively taken oligopolistic collusion amongst add-on insurers to collectively refuse to play ball with the dealerships.

As you might expect, this did not happen.

Am I trying to say the add-on insurers were blameless? Of course not.

I am just saying that it was very difficult for those insurers to wean themselves off a situation that had grown beyond their control, gradually over many years, without suffering large losses (of the financial *and* employment variety).

Dealerships

Clearly, then, it must be rabid car dealer greed that drove all this, and they deserve all the blame?

Again, not altogether, in my view.

While dealers and other distributors were undoubtedly major perpetrators of the problems with the sale of add-on products, through their very own dealerships, like any half-decent detective will tell you, you must always look at motive in order to understand the bad behaviour.

You might imagine that the quintessential car dealer is making huge profits from selling over-priced cars, over-priced finance and insurance and over-priced after-market products, servicing, and repairs.

This turns out to be largely false.

Many dealerships are effectively forced to amalgamate with other dealerships into larger dealership groups so that the pooled resources (i.e., "critical mass") of the group can be used to win the right to be a franchised dealership to a major global vehicle manufacturer (who are, themselves, an increasingly amalgamated bunch).

The major manufacturers expect their franchised dealers to operate out of expansive, glamorous premises, in prime positions, near to large customer bases, in all major Australian cities. Such premises are very costly to rent (or buy) and to (re-re-) refurbish to the perpetually increasing demands of these big global manufacturers.

Furthermore, studies by the Australian Competition and Consumer Commission (ACCC)[3] have shown that car dealerships make very little profit from the sale of vehicles. Historically, greater margins have been made on selling Finance and Insurance (F&I), after-markets (e.g., window tinting, upholstery treatments etc.) and in selling spare parts (for repairs and maintenance). Large margins in F&I sales are now gone and the ACCC is looking closely at spare parts pricing[4] and availability.

These dealerships need to make strong profits to provide healthy returns on the significant investments of capital they have made into big fancy premises to satisfy the manufacturers' demands. The franchising agreements currently give manufacturers considerable freedom to dial up demands on their franchised dealerships if they wish to keep being a franchised dealership.

No franchised dealership can afford to lose their rights to sell the manufacturers' vehicles, before they have had the opportunity to recoup the costs of their investment in premises and related expenditure. This can take 5 years or more.

While there is no "trail" of how MAPs were actually used by dealerships (and undoubtedly, there were instances where the Dealer Principal simply wanted a new boat), it is likely that MAPs were often used to contribute towards refurbishing premises to satisfy a manufacturer.

So, make no mistake, many dealerships were, and still are, under significant pressure to make profits just to preserve the rights to keep selling the vehicles and stay afloat, while their options for alternative profitable sales channels are diminishing.

The ACCC was expected to undertake a review of the Franchising Code of Conduct during 2021, in light of the above. As expected, delays with starting this review (originally due in 2020) were caused by COVID-19.

Senate Committee Inquiry

However, the ACCC review might now be superseded by a Senate Committee Inquiry into the relationships between manufacturers and their franchised dealers. The investigation is already underway and the ACCC were among many parties called before the Committee.

The following is a summary of the scope of the Committee's investigation

a. practices employed by manufacturers in their commercial relations with dealers, with specific focus on
    - investment required and tenure provided
    - termination and compensation practices
    - performance requirements
    - behaviour around warranty claims and Australian Consumer Law
    - unfair terms in contracts
    - goodwill and data ownership
b. existing legislative, regulatory and self-regulatory arrangements
c. current and proposed government policy

[3] https://www.accc.gov.au/focus-areas/market-studies/new-car-retailing-industry-market-study/final-report

[4] The ACCC report noted that an add-on insurer that previously sold extended warranty insurance had found that a small vehicle that cost $21k to buy new (fully assembled) would have cost $114k to buy as spare parts from the manufacturer (fully disassembled).

d. dispute resolution systems and penalties for breaches of the Franchising Code of Conduct
e. current and proposed business models in selling vehicles
f. legislative, regulatory and self-regulatory arrangements found in international markets
g. the imposition of restraints of trade on car dealers from car manufacturers.

A report detailing the findings of the Committee was apparently released on 18 March 2021, although I have been unable to obtain a copy myself.

Manufacturers

Perhaps, therefore, we really ought to blame the "big bully" multi-national manufacturers?

Again, manufacturers have their own pressures that drive these behaviours.

Manufacturers in many countries are recipients of large government subsidies, they invest huge sums into research around vehicle safety, vehicle emissions reductions (including new forms of power) and into meeting and/or re-shaping consumers' continually changing demands.

And they employ a lot of people, directly and indirectly, so governments in at least some of those countries will deem these automotive manufacturers "too big to fail".

The point I am making here, is that it is very difficult to attribute blame to any single source. It is a systemic problem - meaning, literally, the entire system needs attention.

Regulators

Regulators do not cause problems, and they should never be blamed for causing problems like those described above.

However, in my view (and I know I am not alone in this view), some of the "policing" by ASIC, in particular, has perhaps not always been as effective as it might have been.

The following is how I see the situation:

In some ways, the situation with incentive payments (e.g., commission caps) is analogous to the situation that motorists face daily when driving.

On our roads, there are speed limits. There are signs everywhere reminding motorists of speed limits, and speed limits are well ingrained in the psyche of every Australian motorist (especially in Victoria ☹).

If speed limits are broken, there are cops and cameras to hand out fines. If fines don't wake the motorist up to their actions the ensuing loss of licence after 4-5 such offences most likely will.

Imagine, if instead of the current approach to speeding, the "Chief of Traffic Police" repeatedly sat on the sidelines, bemoaning and handwringing about motorists driving too fast, imploring them to drive more slowly, without ever stating explicitly which speeds were deemed by law as "too fast".

Newspaper articles, slots on the evening news and motorway posters, all imploring people to "slow down". Would it work?

I doubt it.

There are always going to be motorists who need the sharp edge of a well-defined law to remind them of what side of the line they need to be on.

Furthermore, some combinations of driver and vehicle would arguably be safer doing 120 km/h than other combinations of driver and vehicle doing 80 km/h on the same road, at the same time, so the issue of what is "too fast" would likely be different for every motorist, either

judged through their own eyes, or through the eyes of others. So "self-regulation" is doomed to fail (and history has proved this time and again in many settings, not just in add-on insurance).

In my view, it isn't fundamentally different with policing the add-on insurance segment.

Firstly, insurers do not really want to pay excessive commissions. The less commission they pay, the lower the retail price of the product, the more they will sell (all else equal). Commissions just bump up retail prices artificially and make products harder to sell. But selling no products at all, because the dealer demands excessive commissions, and won't accept lower commissions, was an even less desirable outcome from an add-on insurer's perspective.

So why not just extend the rule that already applies to CCI and apply it to *all* add-on insurance products? That is, an incentive "speed limit" of 20% of the premium.

Furthermore, if add-on insurers break the "speed limit", fine them. Fine them too many times and they lose their [Australian Financial Services] Licence for a time (or permanently if the message still doesn't get through).

Dealers will not even ask for ridiculous commissions if there is "black letter" law that says it is capped at [20%].

Many might argue that ASIC has effectively done this with their new Product Intervention Powers.

Any product deemed by ASIC to cause "significant detriment" to consumers can be pulled from sale.

Maybe so, but why not add some objectivity to the situation and simply say that significant detriment begins when incentives go north of [20%] of the premium? The boundary line is clear, all market participants understand it, why make it any more difficult than that?

Just imagine if all speed limit signs on our roads were taken down and traffic cops were briefed each morning and asked to fine only those motorists whose driving was deemed to be of "significant detriment" to other motorists[5].

Just imagine all the "what the…" sideways glances in the briefing room.

Surely it is far better to say

- The speed limit is 100 km/h
- If you change lanes you must indicate
- No mobile phone use while driving
- No alcohol or drugs before driving
- etc.

Simple rules where everyone can clearly delineate between right and wrong.

Whether someone agrees with the rules or not is irrelevant.

In my view, it should be the same with "significant detriment" in the case of a known source of detriment (such as incentive payment limits).

[5] *"I've just got a reading on the detriment-ometer of 115, Madam, that's a $500 fine and 4 demerit points"*

Known versus unknown sources of detriment

Having explicit views around known sources of significant detriment (e.g., incentives over 20% of premium) should not preclude ASIC from keeping more general statements about "significant detriment" for any other, as yet unimagined, source of detriment.

As an example of this in the traffic law setting, I am pretty sure there is nothing written down in traffic and roads legislation about wearing a set of stockings over your head while driving. Most would agree it is likely to be significantly detrimental to safety. However, you don't need to list out every conceivable source of detriment to safe driving to make your point. But where there are readily measurable and objective limits to safety, surely, they should be used (e.g., speed limits).

1.2 From 2017 through 2019

During this 2-3-year period we got

- Various reports out of ASIC about all the wrongdoings in the add-on insurance sector[6]
- Lots of media airtime from consumer groups condemning greedy insurers for profit gauging of innocent consumers (a bit of a myth as it turns out)
- Around $130 million dollars of remediation payments to the worst affected consumers of add-on insurance products[7]

and, of course

- The obligatory Royal Commission of Inquiry, which many believe, when all is said and done, cost over $1 billion (i.e., about 8 times the remediation paid to add-on consumers)[8]

Personally, I cannot see any real merit in pecuniary punishment of organisations. They don't really pay. It's as if the shareholders take out a short-term loan from consumers to pay the fine and then default on the loan.

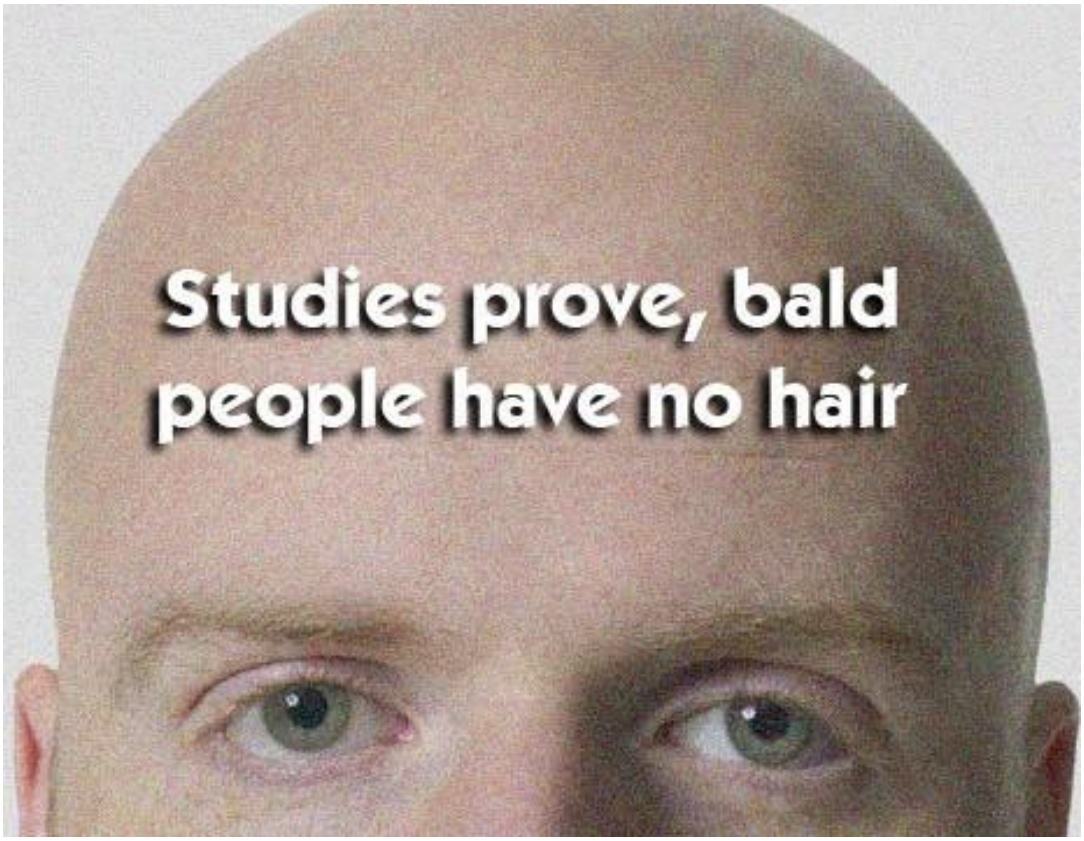
I'm also pretty confident the Australian media clocked up over $130m in profit from the 2-year saga that was the Hayne Royal Commission, which was essentially to examine in great detail, and at great expense, what most people with even a modicum of common sense, already knew to be wholly true.

[6] https://sitesearch.asic.gov.au/s/search.html?query=REP+470&collection=asic&profile=asic

[3] https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-492-a-market-that-is-failing-consumers-the-sale-of-add-on-insurance-through-car-dealers/

[7] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-146mr-asic-announces-further-add-on-insurance-refunds-bringing-total-to-over-130-million/

[8] https://www.afr.com/opinion/banking-royal-commission-may-be-a-billion-dollar-show-20180211-h0vwcg



As far as I am aware, nobody went to jail and only a handful of already very wealthy citizens lost their jobs because of their poor conduct (or failure to prevent it on the part of others).

No doubt they have already found new jobs or have happily retired.

1.3 2020 onwards

As a result of the turbulence of 2017 - 2019, the following has happened (to the best of my knowledge)

- The listed players, IAG, QBE and Suncorp, paid their remediation with relatively little fuss and exited the add-on market in full
- Allianz paid their remediation, exited many classes (e.g., GAP, CCI and Tyre & Wheel) and reduced participation in others (e.g., extended warranty)
- The smaller players largely remain in a much-reduced market, with commissions universally agreed at 20% - 25% of premium; consequently, dealer apathy around selling add-on insurance with much lower commissions has been a feature of the new environment
- Directors & Officers (D&O) Insurers have queried exposures to add-on insurance and, in some cases, applied either loadings or exclusions to D&O premiums/coverage to any entity that chooses to be involved with add-on insurance
- Some major financiers will no longer finance add-on insurance premiums
- There is still some class action activity to play out[9]

[9] https://www.mauriceblackburn.com.au/class-actions/current-class-actions/car-dealer-add-on-insurance-class-actions/?gclid=CjwKCAiAtK79BRAIEiwA4OskBtfyiR2WgthWBAIxO6xiIK3q2Ua71gcxtg6wW2iTVqwbnJJV8aPItBoCCF0QAvD_BwE&gclsrc=aw.ds

- A raft of new legislation has been implemented and is due to commence (at the latest) in October 2021 (deferred 6 months due to COVID-19) and this includes
    - ASIC's new Product Intervention Powers (PIP) - already in-force
    - Design & Distribution Obligations (DDO) on add-on insurers (a major part of which is the Target Market Determination (TMD), where insurers must clearly define their target market, as well as the "negative market" - i.e., those consumers that their products are not intended or suitable for
    - Deferred Sales Model (DSM) - consumers cannot be sold any product until after 4 days have elapsed since making a firm commitment to buy a vehicle (e.g., submitting a finance application). In addition, the consumer must be provided with an electronic road map (i.e. a link to an online portal) and only if the consumer indicates their intention to buy, or makes a request for further information about add-on products, through the portal, can they be contacted after 4 days regarding add-on insurance
    - Commission capping (ASIC now has the powers to do this but has not yet heralded any explicit caps)
    - Unfair Contract Terms (see also comments later on Discretionary Dealer Warranty)
- The remaining add-on insurers are trying to improve pricing - lower prices are now possible with commissions having been almost universally agreed at no more than about 20% - 25% but many legacy issues remain (e.g., MAP intangible asset impairment and ongoing amortisation keeping acquisition cost ratios elevated, an over-sized sales force geared for a larger market that has now shrunk, while demand for regulatory and compliance skills is soaring – not that such people are especially welcome "culturally" in these organisations).
- Some add-on insurers have introduced partial risk rating of premiums
- The previous ombudsman services have all been wound up and replaced by the Australian Financial Complaints Authority (AFCA). AFCA has shown significant "sympathy" for consumers in External Dispute Resolution (EDR) and so claim acceptance rates are now at all-time highs. This will most likely lead to upward pressure on premium rates at a time when ASIC is monitoring premium rates very closely, waiting to see earned loss ratios rise significantly from the levels seen 4-5 years previously
- Even APRA has waded into the debate about "target loss ratios" for add-on products and it appears that many now believe and accept that the observed earned loss ratio for a product provides a guide to its "value" to consumers (I believe it is a little more complex than that and this will be discussed further below)

1.4 Are these changes for the better?

Overall, in my view, these regulatory changes are definitely in the right direction, but there are also some perverse and/or sub-optimal outcomes.

2. Reform Furphies

2.1 Instalment plans versus financed add-on insurance premiums

ASIC condemned insurers and financiers for the readiness with which add-on premiums were financed. As a result, most insurers now provide instalment plans for the premiums and some financiers have already said "no" to ongoing finance of add-on premiums.

In my view, this is unlikely to lead to better financial outcomes for consumers.

Part of the reason why the costs of financing the add-on premium were so high previously was because there were also no ASIC-imposed "speed limits" on financier "flex" commission.

Flex commission

Flex commission is essentially commission paid by financiers (not insurers) to dealerships and other distributors for arranging finance with ever higher interest rates.

A financier might have had a "base" finance interest rate of (say) 6.0% and then financiers paid distributors progressively and disproportionately more commission the higher the interest rate they managed to get a deal financed at. i.e., the commission would "flex" in line with the finance rate.

So much so, that a dealership could make more commission on financing a handful of deals a month at (say) 16.0% interest than if they did many deals at (say) 8.0%.

Rightly, ASIC addressed the issue of flex commission directly, with explicit boundaries to what is acceptable, and largely eliminated excessively high finance interest rates. However, it seems they did not recognise that this would also significantly reduce the financed cost of an add-on insurance premium.

As a result, insurers now have instalment plans, and the "frequency loading" for paying by instalments is arguably comparable to the worst historical interest costs.

There are real reasons for significant frequency loadings.

Consumers behaving badly

Many consumers will prioritise the payment of their finance because default will likely lead to repossession of their vehicle (and is also highly detrimental to their credit score in general).

However, the high incidence of premium instalment dishonours signals that consumers feel no similar compunction to ensure their insurances remain in-force. Insurers are now required to send emails, texts, hard copy letters and make telephone calls to consumers who miss their instalments.

Many consumers simply do not reply to any such communication and inevitably, after numerous attempts to contact the consumer, the policy lapses and is cancelled (with the ensuing "snail mail" cancellation notice and other communications).

Even this is not guaranteed to elicit a response. However, when that consumer needs to claim, suddenly they are very aware of their rights, and while they do not recall any attempts at communication by the insurer, they do indeed wish to reinstate their policy with immediate effect.

Repeated AFCA rulings have told insurers that they will have to reinstate the policy, collect the premium instalment arrears, and then pay the claim.

In other words, for this type of consumer, it appears that *AFCA now ensures that an insurance policy becomes something you only need to pay for when you need to claim*.

This is clearly unfair to those consumers who do the right thing because it costs the insurer (the total instalments never collected from all other "fake lapses", whether they reinstate and claim or not) and these costs are passed on to those who do pay.

It is not clear to me that the legal and consumer advocate communities, and AFCA, have quite grasped the inequity (and financial irresponsibility) of this situation they apparently so favour.

If every consumer took the same stance, there would be no more retail insurance of any kind, add-on insurance or otherwise.

Communication costs money

As you might imagine, all this activity attempting to communicate with the consumer isn't free.

It costs money to send texts, emails, letters and make phone calls and all this activity must also be recorded electronically in insurer IT systems (and not just because ASIC and AFCA often request it).

In many cases, it is the inconvenience of two separate payments (the finance and the insurance) that drives the problem.

In my view, this push for instalment plans over premium financing is a classic case of "throwing the baby out with the bath water".

The cost of a financed premium, at today's low interest rates, with the new controls over flex commission, means that financed add-on single premiums would be clearly cheaper and far more convenient for insurers and consumers alike, and especially compared to instalment plans.

But the perception that financing a premium is not cheaper remains, because it may not have been so previously.

With the 4-day deferral period under the DSM now pending, it is also not clear whether it will even be possible to finance an add-on premium from October 2021.

A financier may not be willing to either

- Pause the finance approval process for 4 days: or
- Give pre-approval for the addition of an add-on premium to the financed amount, if desired

2.2 Still no speed limits or other objective thresholds on incentive payments

ASIC has still not prescribed a "speed limit" for commissions or other incentive payments.

Under their new Product Intervention Powers, ASIC does now have the ability to set commission caps but, as yet, they have not announced any such caps.

As noted above, the add-on insurance industry, almost by some form of telepathic collusion, does seem to have landed somewhere near a "speed limit" range of 20% - 25% transactional commission.

However, while ASIC has hinted indirectly at a threat to remove the conflicted remuneration exemptions that currently apply to general insurance products, they never quite go the next step and state explicitly what sorts of outcomes would trigger such action.

Add-on insurers are very unlikely to pull back from doing something that ASIC doesn't like unless ASIC specifically says "thou shalt not do…".

If an add-on insurer were to pull back voluntarily, while others do not, then market share will inevitably be lost.

In my opinion, and experience, if ASIC wants something to stop, they need to clearly define what it is they don't like and draw a line in the sand to demarcate what is acceptable and what is not.

However, ASIC may also be mindful that if they set commission caps too low (i.e., well below 20%), dealers and other distributors simply won't bother, and a perfectly viable, well-regulated market will effectively be killed off.

The cap will most likely be the mode

ASIC will also need to bear in mind that commission caps, like speed limits, will most likely become the modal commission rate (just as most drivers drive <u>at</u> the speed limit, not slower).

Hidden Incentives

There is also the issue of latent or hidden incentive payments.

One of the key themes in ASIC's regulatory guidance, RG246, relates to the notion of "window dressing" conflicted incentive payments to sound like something else, or even to declare that the payment is for something else when, in substance, it is an incentive payment.

The official terminology is "anti-avoidance".

A good example of this is the notion of an "Introducer Fee" noted earlier.

Distributors are businesses that have expenses (staff, premises, utility bills, plant and equipment etc.). If an Introducer Fee is designed to make a fair contribution to those expenses, then it will need to be demonstrably related to the actual costs of doing business.

For example, suppose a distributor sells 60,000 policies per annum and has total annual expenses of $12m. It should be clear then, that the Introducer Fee ought to be, on average, around $200 per policy, if the purpose of the introducer fee is purely to meet all distribution-related expenses.

If the Introducer Fee is $450 per policy then it is manifestly excessive relative to what is required to fund the expenses of distribution and therefore, in substance, it is loaded with a $250-per-policy pure incentive payment (on top of any transactional commission).

My main question around commission capping (or perhaps total incentive capping) is as follows:

Is it more efficient and effective to state explicitly what the maximum total incentive payment can be (e.g., as a percentage of gross premium excluding GST and Stamp Duty) or is it better to talk in general terms about "significant detriment" and leave insurers (and consumers) to

(a) guess what ASIC thinks might constitute "significant detriment"? or
(b) respond to ASIC only after they have declared "significant detriment" exists?

In my opinion, a total incentive payment cap of 20% of the gross premium (excluding government charges) is reasonable as it

- matches the cap applicable to CCI business (whether sold as an "add-on" or otherwise)
- provides enough income for dealerships and other distributors to survive on

Properly formulated "introducer fees", aligned to true underlying distributor costs, can also be paid over and above commission, and these are not deemed, by me anyway, to be incentive payments.

It seems ASIC is monitoring insurers to see what incentive regimes they devise and deploy without the need for ASIC to announce an explicit commission cap. This may mean ASIC does not get the outcomes they might be hoping for.

2.3 Earned Loss Ratio as *the* measure of value

In various media articles during 2019[10], both ASIC and APRA condemned the lack of improvement in [earned] loss ratios for CCI products.

It was duly noted that ASIC raised concerns with consumer "value" when CCI [earned] loss ratios were measured at around 18% in 2011, and the re-measurement of industry CCI [earned] loss ratios in 2019 at 19% was not deemed to be progress.

However, neither APRA nor ASIC have actually stated what they think **is** an acceptable loss ratio for CCI (or any other product).

[10] https://insurancenews.com.au/daily/is-self-regulation-dead-cci-failure-reveals-size-of-challenge

They have simply suggested that a loss ratio below 20% is unacceptable.

So, is 30% acceptable? What about 40%?

However, in a joint submission to Treasury[11] by

- Consumer Action Law Centre
- Financial Rights Legal Centre
- CHOICE
- Consumer Credit Legal Service WA
- Consumer Credit Law Centre SA
- WEstjustice
- Australian Communications Consumer Action Network (ACCAN)

these groups have done exactly that, indicating that loss ratios for add-on insurance products should be comparable to comprehensive motor insurance at around 90%.

While I do not agree with the 90% loss ratio target (for reasons set out below), at least these groups have put forward an explicit position on acceptable loss ratios, in their eyes.

From my perspective, there are many problems with the consumer group view.

Firstly, no insurer can survive on a mono-diet of 90% loss ratios.

Comprehensive motor insurance **gross** loss ratios might be around 90% but they will make significant recoveries from

- Reinsurance arrangements
- Non-reinsurance recoveries (e.g., third-party recoveries from insurers of at-fault drivers, salvage etc.)

meaning **net** loss ratios are more likely to be in the range 65% - 75% (on average).

Add-on products are not generally reinsured and there is little, if any, non-reinsurance recovery activity with add-on insurance.

Comprehensive motor vehicle insurance (MVI) is a very competitive market, and in my estimation, many insurers would declare only thin profits on this class, if any. Often, MVI is used as a loss-leader to also acquire (say) the CTP premium for the same vehicle, insurance of second or third vehicles, or indeed the home and/or contents policies for the vehicle owner(s).

Some add-on insurers loss-lead with comprehensive MVI in an attempt to keep other add-on insurers out of a dealership because all car buyers need comprehensive MVI - especially those buying with finance (the vast majority). However, add-on insurers who sell loss-leading comprehensive MVI must make sure that sufficient add-on insurance is also sold so that the overall package of sales from the dealership is profitable.

Other insurers may loss-lead with comprehensive MVI as a "sweetener" to also getting all the dealership's commercial insurances (e.g., the dealer premises and stock, public liability, etc.).

Secondly, comprehensive motor policies are mostly annually renewable. This means the profit margin in any MVI policy only has to service supporting capital for up to 12 months. Premiums can also be increased at renewal if experience is worse than previously expected.

Most add-on insurance products have policy terms of 36 to 84 months, so the profit margin generally has to be larger as a percentage of the premium, because capital has to be supported for a longer duration out of that single upfront premium. Once the upfront premium has been charged, there is no scope to charge additional premium if the experience over the

[11] https://consumeraction.org.au/wp-content/uploads/2019/10/Joint-Submission_Reforms-to-add-on-insurance_Proposal-Paper_final.pdf

next 3 - 7 years proves relatively unfavourable. So, these longer duration policies have a different risk profile for an insurer.

Note also that a premium instalment plan does not provide scope to increase rates either. It is simply a plan to pay the otherwise fixed, upfront, single premium over the instalment plan term.

As noted above, MVI is heavily reinsured and reinsurance is inevitably a cheaper form of capital than the insurer's own capital (why else would an insurer buy reinsurance?). There is currently very little, if any, appetite for reinsurance of add-on products. This is probably because financial products like CCI and GAP have considerable exposure to economic downturn risk; CCI policies often cover unemployment, while GAP policies are exposed to vehicle value depreciation risk, which can be elevated during economic downturns, and GAP also has exposure to natural peril accumulation events such as hailstorms.

So, add-on insurers must provide their own (Tier 1) capital in support of their business and cannot, in general, rely on the availability of reinsurance at a lower cost of capital than their own hard capital.

Thirdly, in the case of extended warranty especially, I have seen numerous examples where non claim payment activity has a material and positive impact on "value" being provided to consumers.

The following provides background and an example of such value-adding behaviour.

An add-on insurer's warranty claims team will inevitably consist of staff with significant prior automotive mechanical experience.

These people have a good working knowledge of

- What a given repair ought to cost (because of their own knowledge and experience as well as from actuarial analysis of past claims of a similar type)
- Where best to source parts and labour from (and where to avoid)
- The manufacturers who insist on using "sealed units" (so that, if a small part of the sealed unit fails, you must replace the entire unit) and how to get around this issue

Example

Consider a consumer that starts their vehicle one day and the engine light comes up on the dashboard to signal there is an issue.

The consumer takes their vehicle to the franchised dealer who advises them that a sensor on the catalytic converter has failed and they will need a new catalytic converter. The total cost of the new part, including fitment, is $4,000.

Catalytic converters are notoriously expensive because they contain many precious metals (e.g., Platinum). No doubt there are always good reasons why parts are so expensive.

The catalytic converter is also an example of a "sealed unit"; while only the sensor failed, it is not possible (according to the manufacturer) to just replace the sensor.

Over the past 6 years, the affected vehicle has travelled 120,000 kms since new, so this is not an altogether unexpected event. The manufacturer warranty expired over a year ago and it

is unlikely the owner would have any remaining rights under the Australian Consumer Law (ACL) on a vehicle this old and with this odometer reading.

Many other sensors will be wired to the same dashboard light so there is little question it will have to be fixed.

If the consumer has no warranty insurance, they will almost inevitably feel they have to spend $4,000 replacing the entire catalytic converter because, if some other engine component failed, they would never know it had failed (a single dashboard light cannot be "doubly on"). The franchised dealer will almost certainly "scare" the consumer with this possibility.

Franchised dealers will not, in general, repair using used parts, even on a vehicle that is 6 years old.

Now, if the consumer had extended warranty insurance, their insurer could firstly find a used, but guaranteed, catalytic converter (or even just a replacement sensor). In fact, an insurer sources just such a used part from a vehicle of the same make and model that was written off after an accident at 25,000 kms. The cost of the used part is $800, including fitment, and is effectively guaranteed until the end of the warranty policy term (over 24 months away).

Had the consumer tried to locate a comparable used part themselves, they would not have been able to arrange for the parts and labour at the same cost (they would have had to pay closer to $1,200) nor would they have necessarily received any guarantee.

The issue with focusing on the loss ratio as *the* measure of value means the warranty insurer would only be able to attribute $800 to the numerator of the loss ratio calculation, because that was the warranty claim payment.

The insurer's expense of sourcing the parts and labour is also not included.

However, the insurer's expertise and knowledge, and ability to use their position as a bulk purchaser of parts and labour to get better pricing, means the consumer avoided having to pay either $1,200 (assuming they also had the time and knowledge to source the second-hand part) or they would have had to pay out $4,000 to have a brand-new part fitted on a vehicle that is already quite old.

The warranty insurer will also often be able to "queue jump" to ensure their insured customers get prioritised service at a vehicle repairer they do a lot of business with.

In my view, the "value" provided to the consumer of warranty insurance in this example is significantly north of $800, and that the act of containing claim costs to $800 also helps keep future warranty premiums lower.

It is sometimes said that

$$VALUE = \frac{WHAT\ I\ WANT}{WHAT\ I\ PAY}$$

What this equation says, among other things, is that paying for things you don't want is not getting high value.

In my view, there are insurance products out there that have high loss ratios, purely because the numerator is packed full of "benefits" that not everyone wants (or needs), and the denominator (i.e., what you pay) is therefore unnecessarily large because of it.

Conversely, the warranty example above illustrates how a simple measure like loss ratio does not adequately capture all aspects of "value".

So a high loss ratio is not necessarily synonymous with high value (although I am more than happy to concede that low loss ratios inevitably mean low value).

2.4 What is a reasonable loss ratio then?

Most would agree, a continuation of products that generate loss ratios below 20% is totally unacceptable.

My personal view is that any **long-term** earned loss ratio below 30% is also universally unacceptable (although general volatility in outcomes might cause low earned loss ratios to arise for a short time).

However, it seems unlikely to me that add-on insurers could routinely match MVI (net) loss ratios of 65% - 75%. As alluded to above, MVI may be an example of an insurance product with a high loss ratio but not, in all cases, one with high value.

But that's a story for another day.

With dealers taking 20% - 25% commission it is almost impossible to imagine an add-on insurer surviving profitably on the remaining 5% - 10% of premium.

My own personal view, is that add-on insurance products can provide reasonable total value to consumers, when they are generating loss ratios of around **40%** over the long term, bearing in mind

- The value also provided to warranty consumers by selecting the most efficiently priced repairs, using bulk purchasing power and expertise to keep costs down and to provide prioritised service
- The lack of availability of reinsurance for GAP and CCI products which have significant economic downturn exposure (with GAP also having hailstorm exposure)
- That the policy terms of add-on products are largely in the range 3-7 years and there is no opportunity to recoup additional premium if experience turns out worse than expected
- Regulatory compliance costs for add-on insurance under the new legislation and regulations are not going to be cheap. It costs a lot of money to design, build and then maintain IT systems and other processes to satisfy the new regulations - these same regulatory compliance costs will not apply to non-add-on insurance (e.g. comprehensive motor insurance)
- AFCA is still, in my view, excessively "sympathetic" to add-on consumers who are not, in all cases, really keeping up their side of the insurance contract and acting in utmost good faith

If the premiums are also highly risk-rated, so that each consumer has a similar expected loss ratio, then this will further significantly enhance the fairness of these products.

2.5 Pro rata refunds

2.5.1 Premium recognition and premium earning patterns

Premium written on the day a policy is sold cannot be recognised immediately in an insurer's Profit & Loss account.

Instead, under the Australian accounting standard, AASB 1023, general insurers are required to form a view of a reasonable pattern of the emergence of risk under the contract, and earn the premium written at inception, over the life of the contract, in accordance with the adopted risk emergence pattern.

In general, an actuary (e.g. the Appointed Actuary) will analyse past patterns of claim emergence (i.e. both the claim amounts being paid and the timing of the events giving rise to those payments), along with any other relevant information they have available, and make recommendations to the insurer about the premium earning patterns to adopt.

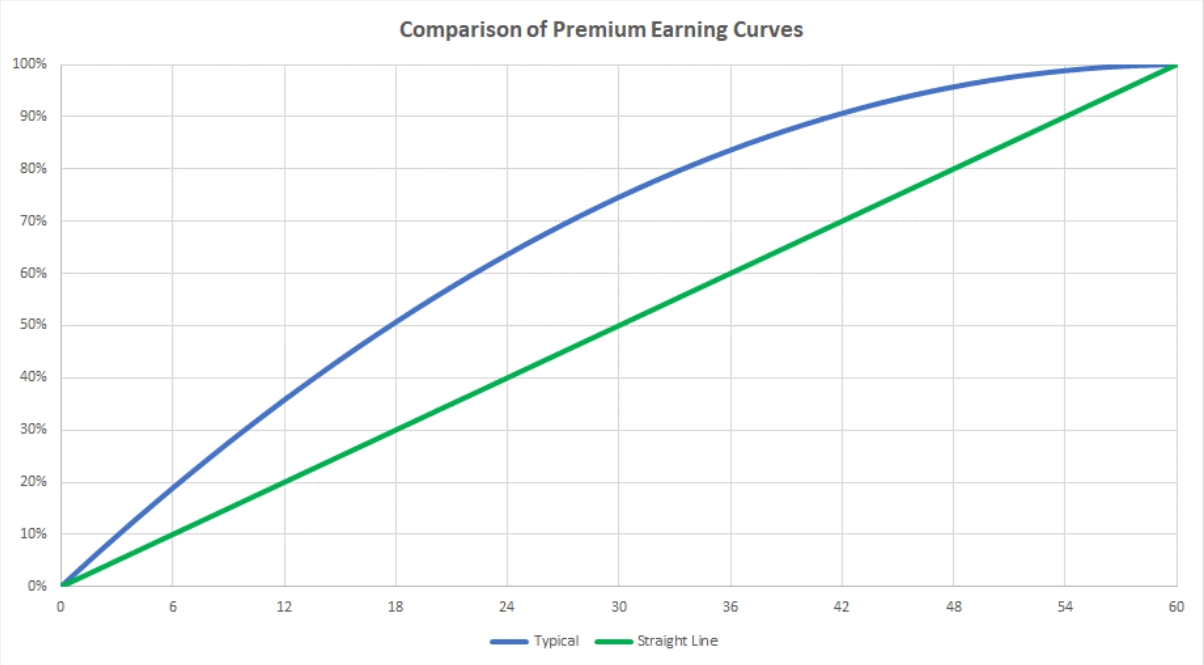
Typically, this process would also involve the insurer's Appointed Auditor, so that the Appointed Auditor is in broad agreement with the insurer around revenue recognition.

2.5.2 Typical earning patterns for multi-year add-on products

Premium earning patterns for multi-year add-on products are invariably non-uniform. That is, the earning of premium over the life of the contract (i.e. the policy term) does not follow a straight line.

Empirical analysis of claim emergence patterns (as described in 2.5.1 above) will generally suggest a premium earning pattern that is more rapid early in the term of a multi-year policy, but gradually eases later in the term. It isn't always obvious why this should be so but, regardless of the reasons, the observed claim cost emergence patterns inevitably show this same basic shape and AASB 1023 obliges insurers to conform to this pattern of risk emergence in the premium earning patterns they adopt.

The following chart illustrates the differences between straight line earning of premium versus a typical pattern where the earning of premium is faster at first but steadily slows over the term:



Notably, for example, mid-way through the term

- Under straight-line earning, 50% of the premium has been earned
- Under a "typical" convex earning curve, almost 75% of the premium has been earned

In the above example, AASB 1023 would oblige an add-on insurer to adopt an earning curve similar in shape to the blue curve for most multi-year business.

For example, an insurer that wrote a 60-month policy for $1,000 would earn that premium non-uniformly in accordance with the blue curve

- $357 in year 1
- $279 in year 2
- $200 in year 3
- $121 in year 4
- $43 in year 5

as opposed to $200 per annum for 5 years under uniform earning (per the green line).

2.5.3 Refunds

An actuarially "fair" premium refund would return the Unearned Premium Reserve (UPR) held against the policy, less a small administration charge or cancellation fee.

If a policyholder were to cancel their 60-month policy after 36 months, the starting place for the refund would be the UPR = $121 + $43 = $164, per the above blue curve.

A $50 cancellation fee (say) might be applied giving a net refund of $114 to the policyholder.

If the insurer is forced to provide a pro rata refund, the net refund at 36 months would be $350, more than 3 times what is actuarially "fair".

There are only two choices for an add-on insurer under enforcement of pro rata refunds

- Make no change to premium rates and pay excessive (pro rata) refunds to policyholders and suffer financially through lost earned premium revenue
- Adjust premium rates upwards to cater for the artificially excessive (pro rata) refunds

Notably, **an insurer does not earn premium which is refunded**, so raising premium rates to fund excessive pro rata refunds will have absolutely no impact on an insurer's earned premium revenue and therefore applies absolutely no downwards pressure to the insurer's earned loss ratios.

As a result, rational add-on insurers will be forced to take Option 2 above - needlessly raising premium rates to fund an excessive refund amount, with absolutely no risk to the insurer that their earned loss ratios will be depressed to a point that calls "customer value" into question.

The following table provides an indication of the likely impact on premium rates depending on the policy term and the average monthly cancellation rate expected.

The table shows the loading to premiums required to fund paying pro rata refunds instead of "Rule of 78" refunds.

	Average Monthly Cancellation Rate					
Term	**0.5%**	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**
12	0.9%	1.8%	2.6%	3.4%	4.1%	4.8%
24	1.8%	3.5%	5.1%	6.4%	7.7%	8.8%
36	2.7%	5.1%	7.2%	9.0%	10.4%	11.6%
48	3.6%	6.6%	9.0%	11.0%	12.4%	13.5%
60	4.4%	7.9%	10.6%	12.5%	13.9%	14.7%
72	5.2%	9.1%	11.9%	13.7%	14.8%	15.4%
84	6.0%	10.2%	12.9%	14.6%	15.4%	15.7%

Other than in the top-left corner of the above table, these loadings are not trivial.

While pro rata refunds have *prima facie* "intuitive appeal", the financial reality is that they disturb the natural balance between an insurer's requirements under AASB 1023 and what is actuarially fair in the case of a refund.

2.5.4 Lenders Mortgage Insurance (LMI)

Almost 10 years ago now, a Bill was introduced to parliament to improve the portability of home loans,

A key feature of the Bill was the notion of pro rata LMI premium refunds for low deposit borrowers who had been required to purchase LMI.

A borrower that pays an LMI premium as part of a 25-year loan with a small deposit, may believe that, after 5 years, if they sell their existing home in order to buy another property, that they are entitled to a pro rata (i.e. 20/25 = 80%) refund of LMI premium.

However, the emergence of risk for a mortgage insurance policy is highly non-uniform. In fact, typically, around 90% of the LMI premium is earned in the first 5 years of low deposit home finance, as Home Price Appreciation (HPA) tends to be the dominant driver of equity creation early in the life of a low deposit home loan (with only a small contribution from loan balance amortisation via mortgage repayments).

Even if the borrower loses their job and defaults on their loan after 5 years, it is highly likely there is already sufficient equity in the property so that the proceeds from any forced sale are sufficient to clear the outstanding loan balance (meaning no LMI claim to pay and hence no risk to emerge).

Consequently, at the 5-year stage of a typical, low deposit, 25-year home loan, the UPR will be approximately 10% of the original LMI premium paid.

It is simply not possible to pay 80% of the original premium as a refund when the UPR is already down to 10% of the original premium (without over-paying by a factor of 8 times on the refund). This would be grossly actuarially unfair.

Fortunately, the pro rata LMI refunds part of the Bill was thrown out (and arguably, for the reasons set out above).

The above LMI situation therefore creates something of a precedent in relation to the folly of pro rata refunds on multi-year contracts with non-uniform premium earn out.

2.5.5 ASIC needs to re-examine allowable refund schedules

It is my firm view that ASIC needs to re-examine their views on refund schedules for add-on insurance because, if they do not, there will be a significant mismatch between the premium earning pattern required to comply with AASB 1023 (and hence the Unearned Premium Reserves held at any time) and the insurer's refund obligations (in the absence of an adjustment - as per 2.5.3 above).

If ASIC is seeking a unified approach to refund schedules, I believe a reasonable compromise would be to allow insurers to adopt "Rule of 78" refund schedules, exactly as mandated under the National Consumer Credit Protection (NCCP) Act (2009) as it relates to Consumer Credit Insurance (CCI) refunds. CCI is also a multi-year add-on insurance product.

A "Rule of 78" refund schedule would be expected to introduce significantly less mismatching between premium earning and actuarially fair refunds.

In fact, insurers may even reasonably be able to adopt the "Reverse Rule of 78" curves for premium earning and have no mismatching with their refund schedules at all.

2.6 A bit of a backflip, with no reasons given

On 9 March 2021, ASIC announced quietly, through the Insurance Council of Australia (ICA), that the draft Product Intervention Order (PIO) released on 5 August 2020[12], which set out a range of selling and other conditions to be mandatorily imposed specifically upon the **automotive** add-on insurance sector, would **not** proceed.

ASIC gave no reasons for this backflip.

[12] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-179mr-asic-consults-on-proposed-product-intervention-order-for-the-sale-of-add-on-motor-vehicle-financial-risk-products/

The draft PIO included significant guidance around automotive extended warranty in particular

- Defining when an automotive extended warranty product could be sold (so that overlapping coverage with manufacturer and/or statutory warranty did not occur)
- Minimum individual claim cap ($2,000) for any product
- Servicing requirements (e.g. cannot force policyholder to service vehicles under 10 years old more frequently than manufacturer specifications and cannot force policyholders to get vehicles serviced and repaired at specific dealerships)

As the next chapter of this paper will discuss in greater depth, the automotive extended warranty market in Australia extends well outside of the insurance sector and creates numerous opportunities for regulatory arbitrage - whereby dealerships can legally issue their own products, outside of ASIC's regulatory reach, and charge consumers excessive prices for what is often a low-quality, low value product.

In the end, the only guaranteed armament for consumers in how to avoid being sold one of these low or no value warranty products is to get themselves educated.

2.7 Summary

This section of the paper highlighted that, in my opinion, some of the reforms

- Do not go far enough
- Over-simplify a complex issue
- Provide a "cure" worse than the original "disease"

In my view

- Objective boundaries between "right" and "wrong" should be adopted wherever possible. Such boundaries (e.g. "speed limits") are readily understood and act to simplify the situation. Furthermore, objectivity does not have to be limiting – you can still have laws against "reckless driving" and "driving faster than 100 km/h" sitting side by side without one diminishing the value of the other.
- The concept of "value" in buying an insurance product is more complex than that captured by a simple loss ratio. There is no doubt that a loss ratio is a key part of the value assessment, but it is not the "be all and end all"
- Instalment plans for paying premiums (as opposed to financing the add-on premium) and pro rata refunds (as opposed to a refund that more closely aligns with the premium earning pattern) might seem reasonable at first glance, but on closer inspection, they do not pass muster – and, in fact, make the cost of insurance unnecessarily greater

Perhaps you might feel that I have gone a bit hard on ASIC. Maybe I have.

But consider your favourite football code.

Referees do not start punch-ups, they do not gouge eyes, bite ears and tackle players' heads with their shoulders and elbows.

Referees do not cheat, they do not sledge and they do not make up the rules on the fly.

However, a referee that doesn't enforce the rules, that doesn't get out the red and yellow cards when player conduct warrants it, will soon become the target of most supporters' vitriol.

It's probably a bit unfair. But it does serve to underline just how important it is to have fair rules and a good referee. Without a good referee, there is no game, just chaos.

3. Dispelling a few myths

3.1 Warranty is just "junk" insurance, and the ACL protects consumers anyway

In some ways, despite the significant regulatory actions led by ASIC over recent years, the Australian "auto-warranty" market is still a bit of a muddle and it is reasonably easy to see how consumers can end up with largely worthless products if they do not understand the subtle nuances of, and differences between, the many and varied options.

In my opinion, the auto-warranty market still needs work, and especially now that ASIC has walked away from its draft PIO (per 2.6 above). But to avoid the "baby out with the bath water scenario" (again), in my view, there needs to be widespread understanding of its current structure and features before any further changes are made.

The fundamental issue is that **not all "auto-warranty" is created equal**.

There are three main types of auto-warranty coverage that I am aware of

- "Exclusion" warranty
- "Inclusion" warranty
- "Discretionary" warranty

and three broad categories of warranty issuer

- General Insurers (regulated by APRA and ASIC)
- Australian Financial Service Licence holders who are not General Insurers (regulated by ASIC only)
- Dealerships (not directly regulated by either APRA or ASIC)

The quality and value differences between these three types of warranty product are substantial and these differences can be exacerbated by the type of warranty issuer and who they are, or are not, regulated by.

Exclusion warranty is the highest quality product type.

Automotive manufacturer warranties are exclusion warranties and an exclusion warranty effectively extends the manufacturer warranty for a further period (measured in time and/or kilometres).

They are called "exclusion" warranties because all mechanical and electrical components are covered except those which are excluded. The excluded component list is generally

- Relatively short (i.e., not many components are excluded)
- Confined mostly to consumable/serviceable items such as brake pads, oil filters and tyres

A full exclusion warranty is perhaps what a "reasonable person" would classify as "5-star".

As a vehicle ages, it naturally depreciates in value while the risk of component failure increases. To ensure that the extended warranty premium remains proportionate to the value of ageing vehicles, individual claim capping is sometimes used to provide slightly lower product gradings.

For example, an exclusion extended warranty on a vehicle that has travelled 140,000 kms already, with a $5,000 per claim cap, would be deemed "4-star" and is still, in my view, an excellent product (not least because typical auto warranty claim sizes are around $1,500).

Inclusion warranties can also be of acceptable quality, *provided consumers understand their limitations*.

An inclusion warranty is so named because the covered components (i.e., those included) are listed out in policy documentation. The issue that needs to be understood is that modern vehicles have a great many components and, while the inclusion list can appear (perhaps deceptively) long, there may be many other components, which are also subject to failure, which will not be covered by inclusion warranty.

The excluded components are, in general, not explicitly listed out, as they are for exclusion warranty.

On-line forums will occasionally give bad press to inclusion warranty, perhaps if there was some kind of implicit expectation on the part of a consumer that the product they bought was an exclusion warranty.

Disappointment is often borne of disproportionate expectations - the sales process should make it clear what the consumer is (and is not) getting for the premium they are paying. In future, Target Market Determinations (TMDs) will almost certainly spell this out for consumers.

Inclusion warranties are most suited to older vehicles (say 10 - 15 years old) with higher odometer readings (say above 160,000 kms). As noted above, an inclusion product has restricted coverage to keep the premium proportionate to the declining value of an older vehicle.

Most inclusion warranties also come with individual claim caps. ASIC did indicate in their now withdrawn draft PIO (see section 2.6 above) that extended warranty individual claim caps must be **at least $2k**. However, it is possible to get inclusion warranties with higher caps.

So long as consumers accept and understand that **inclusion warranty only provides partial protection** against unexpected repair costs, the product can still be relatively good value for money (so long as the premium isn't stacked with incentive loadings for distributors).

An inclusion warranty, with an individual claim cap of $3k or more, is perhaps what a "reasonable person" would classify as "3-star".

In my opinion, lower individual claim caps would be "2-star" at best (and only barely acceptable in terms of product quality) and, in my view, any warranty product with a claim cap below $2k is "junk".

Furthermore, exclusion and inclusion warranty products are, more often than not, **insurance** products. This means consumers are provided with

- The security of knowing the insurer has to continually comply with APRA's stringent regulatory capital requirements and the establishment of adequate, annually audited reserves to cover claim payments, with a very high probability (> 99.5%)
- Access to bespoke, industry consistent, Internal Dispute Resolution (IDR) and External Dispute Resolution (EDR) processes for reduced and/or declined claims
- Insurers being bound by the Insurance Council of Australia (ICA) General Insurance Code of Practice (GICOP) which relates to, among other things, standards of service a consumer can reasonably expect to receive (including quality and timeliness) and treatment of consumers during periods of financial hardship and during claim disputes
- A clear statement of what the product is, the features and benefits, basic information about the claim procedure and so on, in a Product Disclosure Statement (PDS)

In the event of needing to make a claim, these aspects of an insurance offering help define its value at least as much as any expected loss ratio.

Discretionary warranty can be of questionable quality and, in some cases, of unacceptable quality.

There are two main types of discretionary warranties

- Discretionary Risk Products (DRPs) - which are miscellaneous financial products issued by Australian Financial Services Licence (AFSL) holders
- Discretionary Dealer Warranties (DDWs) - which are not classified as financial products because they meet the requirements for the "incidental product" exemption under section 763E of the Corporations Act (2001).

Discretionary Risk Products

DRPs are sometimes promoted as "insurance alternatives". In my view, there is some merit to this claim.

The key difference between an insurance policy and a DRP is

- Under an insurance policy, the protected person (the insured) has the contractual right to have their claim **paid** (if the claim meets all the policy terms and conditions)
- Under a DRP, the protected person has the right to have their claim **considered** and for a decision to be made about paying the claim (the exercise of discretion)

In other words, with DRPs, the payment of claims, even valid claims, is at the discretion of the issuer.

At first glance, this could "raise eyebrows".

However, because the DRP issuer is an AFSL holder, and therefore regulated by ASIC, the incidence of unfair use of discretion should (in theory, at least) be low level, noting also that such AFSL-holders must

- Hold and demonstrate capital reserves (although lesser requirements than for insurers)
- Have an Internal Dispute Resolution (IDR) process and be a member of the Australian Financial Complaints Authority (AFCA) for External Dispute Resolution (and therefore be bound by AFCA's findings on any dispute) - exactly as for an insurer
- Have Product Disclosure Statements (PDS) and Financial Services Guides (FSG) registered with ASIC - exactly as for an insurer
- Demonstrate supervision over Authorised Representatives (who are also registered with ASIC) - exactly as for an insurer
- Ensure their products are sold by individuals that have Tier 2 accreditation and have completed the required product training (per ASIC's RG 146) - exactly as for an insurer

A DRP issuer that plays by ASIC's rules should be delivering a reasonable product to the market.

Discretionary Dealer Warranties

Dealerships are able to construct their own non-financial warranty-like products (most often called Service Contracts).

Service Contracts are <u>not</u> deemed to be a financial product under the ASIC Act (2001) because they meet the requirements for the "incidental product" exemption under section 763E of the Corporations Act (2001). This is because Service Contracts are sold by dealerships, who have a direct interest in the vehicle the Service Contract relates to.

Not all Service Contracts are discretionary but there are certainly some Service Contracts that are.

Service Contracts, more generally, are discussed further below.

From a consumer perspective

- Neither APRA nor ASIC has any formal jurisdiction (yet) over dealers and their DDW products
- There are no formal requirements around capital or reserving for DDWs. The consumer is effectively required to make their own assessment of the likelihood of the dealer becoming insolvent - ironically, the discretionary nature of the warranty provides dealerships with some ability to reduce insolvency risk (by simply declining valid claims).
- There are no formal, bespoke IDR and EDR services available as there are with insurance and other AFSL-holder products. DDW consumers' only real recourse to EDR is to the Civil and Administrative Tribunal (CAT) in their State or Territory and this process is both costly and time consuming (and largely pointless, for what is often going to be a relatively small claim). Furthermore, success at your local CAT does not guarantee you will ever receive payment
- There are no formal requirements placed on dealers selling DDWs around supervision of sales staff, training of sales staff, or on the provision of Product Disclosure Statements that would satisfy ASIC's RG 168 (although some of these activities may be at least partially undertaken by dealers voluntarily)

However, it is a moot point whether a "half-baked" proxy for a PDS actually helps consumers make better choices because, the proxy PDS may give an impression of formality that is unwarranted (pun intended) and the consumer might have been instinctively "warned off" by a lack of any such documentation.

Commission on DDWs

Not surprisingly, DDW products also tend to have the highest levels of commission[13].

Some say up to 80%.

But, if you think about it, at the dealer's discretion[14], it could be 100%...

Outsourcing to Third Party Administrators

A further common feature of DDWs, being issued by dealerships, is that the claims management and other activity may be outsourced to a third-party administrator (TPA). The TPA effectively runs the DDW programme for the dealer (and, in fact, may run many such programmes for many dealers across Australia simultaneously).

The TPA effectively "disconnects" the consumer from the dealership and means the dealership can deflect any issues related to the application of discretion to DDW claim decisions, onto the TPA. The TPA may not even have an AFSL and is therefore unlikely to have a dispute resolution service comparable to those offered by AFSL-holders (and certainly there will be no recourse to EDR through AFCA).

It remains to be seen whether these TPAs will be captured by ASIC's upcoming "Claims Handling as a Financial Service" regulations, or indeed the pending Unfair Contract Terms (UCT) legislation puts an end to their operations.

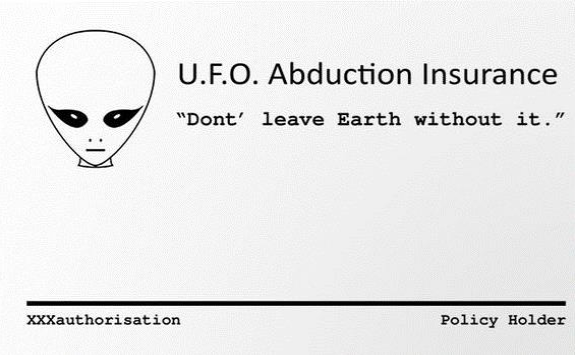
Naturally, the discretionary powers of the dealership (and hence any TPA) to decline even valid claims means the potential for disputes is significantly elevated while the lack of EDR means consumers have no real dispute resolution service of substance, and dealers and their TPAs, knowing this, have little incentive to change their decision making.

So, despite the similar sounding name, DDWs are, in my opinion, vastly inferior to DRPs.

[13] Although it might be commission by another name – e.g. "dealer margin"
[14] i.e., by never paying a claim

It remains to be seen whether DDWs will be banned from sale in Australia under the soon to be enacted UCT legislation.

In my view, DDWs would be the most deserving of the "junk insurance" moniker except, of course, that DDW isn't actually **insurance**.



Service Contracts (a.k.a. Contract Warranty)

These are perhaps the most specious of all warranty-like products because some Service Contracts may be characterised or described in contract documentation as appearing similar, if not identical, to exclusion or inclusion insurance warranty (as described above) and may therefore appear to be a reasonable quality product (although, as noted above, some Service Contracts are DDWs).

However, Service Contracts are **not** retail insurance products, meaning they are **not** issued by an APRA-licensed general insurer directly to a consumer (nor are they issued by non-insurance AFSL-holders directly to a consumer).

As a result, consumers purchasing a Service Contract do not necessarily enjoy the many benefits of retail insurance warranty including (and I know I'm repeating myself here[15])

- The security of the issuer having to continually comply with APRA's stringent regulatory capital requirements and the establishment of adequate, annually audited reserves to cover claim payments, with a very high probability (> 99.5%)
- Access to bespoke, industry consistent, Internal Dispute Resolution (IDR) and External Dispute Resolution (EDR) processes for reduced and/or declined claims
- Issuers being bound by the Insurance Council of Australia (ICA) General Insurance Code of Practice (GICOP) which relates to, among other things, standards of service a consumer can reasonably expect to receive (including quality and timeliness) and treatment of consumers during periods of financial hardship and during claim disputes
- A clear statement of what the product is, the features and benefits, basic information about the claim procedure and so on, in a Product Disclosure Statement (PDS)

As noted above, Service Contracts are not deemed to be financial products under the ASIC Act (2001) because they meet the requirements for the "incidental product" exemption under section 763E of the Corporations Act (2001).

ASIC's jurisdiction over such products and their distributors is therefore moot and the only real protection a consumer of Service Contracts currently has is under the Australian Consumer Law (ACL).

Consumers of Service Contracts will therefore only have recourse to their local Civil and Administrative Tribunal (CAT) for the resolution of any disputes (and, as noted above, this is unlikely to be an effective forum for such disputes - particularly discretionary contracts).

[15] US Marines 3-step approach to teaching: "(1). Tell 'em what you're gonna tell 'em, (2). Tell 'em (3). Tell 'em what you've told 'em"

SCRIPs

Note that while some dealerships bear the uncertainty (i.e. risk) associated with repair costs under a Service Contract themselves, some dealerships choose to "reinsure" their uncertain obligations with insurers using a Service Contract Reimbursement Insurance Policy (SCRIP).

However, it is important to note that, under such arrangements, there is no relationship between the insurer and the consumer with the Service Contract. The dealer has a direct relationship with the consumer but only the dealer has any relationship (and contract) with the insurer (i.e., the dealer is the insured, **not** the consumer).

In fact, the consumer most likely has no idea the dealer has even "reinsured" their exposure.

The insurer also has no clear obligation to the consumer in the event the dealer goes insolvent (and because the consumer, in all likelihood, does not even know of the insurer's existence, they are unlikely to ever attempt to pursue the insurer for indemnity, in the event the dealer does go bust).

At face value, some might believe that once the dealer has "reinsured" their exposure to uncertain Service Contract repair costs with the insurer, the dealer has no further interest in controlling claim costs (i.e. moral hazard) and so a consumer buying a Service Contract need not fear claim disputes, because the dealer will simply insist the insurer pay up to keep the dealer's customer happy.

However, the dealer will also be interested to maintain their relationship with the insurer, and a key part of that relationship will be managing realised loss ratios on the business, and what that translates to, in terms of ongoing SCRIP premium rates.

The Service Contract Fee (100% funded by the consumer) consists of

- "dealer margin" (not commission 🤨)
- The insurer's SCRIP premium for assuming liability for the uncertain repairs

and, while both components are subject to GST, only the insurer's SCRIP premium component of the fee is subject to Stamp Duty.

This contrasts with a retail insurance premium inclusive of commission, which is 100% subject to (GST and) Stamp Duty.

Why would dealers want to sell Service Contracts?

As above, it is debatable whether ASIC has any jurisdiction over the dealer and their "incidental" Service Contract product - it is **not** a financial product.

Consequently, these products may escape the confines of any ASIC commission capping (or other regulatory restrictions to protect consumers from poor financial outcomes) and so dealers can still sell these products legally with ~~commissions~~ "dealer margins" well in excess of the 20% - 25% self-imposed commission caps currently applicable to insurance warranty.

Don't be surprised by dealer margins of 50% (i.e. a 100% mark-up of the insurer's pure SCRIP premium) or more.

To keep the **retail** price of the Service Contract competitive with insurance products that have commission rate restrictions of 20% - 25%, it will be more difficult to offer "exclusion" Service Contracts and still pay a 50% ~~commission~~ dealer margin, so the coverage will generally need to be stepped down to "inclusion" so that the Service Contract fee is somewhat aligned to "exclusion" warranty insurance premiums (with dealers betting that consumers do not know the difference).

Example

Consider two insurance warranty products paying 20% commission to dealers

- An exclusion warranty that sells for $1,600 plus GST and Stamp Duty
- An inclusion warranty that sells for $1,000 plus GST and Stamp Duty

The premium net of commission for the insurer is

- $1,280 for the exclusion product
- $800 for the inclusion product

As an alternative, suppose a dealer constructs a comparable inclusion Service Contract that provides 50% "dealer margin" but also sells for $1,600 before any government charges.

Net of dealer margin, as expected, the "pure" SCRIP premium is $800 (which is directly comparable to the inclusion insurance warranty premium, net of commission, just above).

However, in selling the Service Contract, the dealer receives $800 in dealer margin versus

- $200 in commission if they had sold a comparable inclusion insurance warranty for $1,000 plus GST and Stamp Duty
- $320 in commission if they had sold a superior exclusion insurance warranty for $1,600 plus GST and Stamp Duty

Either way, this is a vintage example of a conflict of interest that goes undetected and unpunished, hundreds, if not thousands, of times a week all across Australia.

So, depending on which dealership they go to, for $1,600 plus applicable government charges, the consumer can either have

- An exclusion insurance warranty, paying the dealer $320 in commission
- An inclusion Service Contract (i.e. a material product downgrade), paying the dealer $800 in ~~commission~~ dealer margin

Dealers that sell Service Contracts are therefore unlikely to even offer insurance warranty, so any consumer going to such a dealer will end up with the Service Contract if they want **financial** protection from uncertain repair costs - from a product, deemed by legislation, to be **non-financial**.

Insurer appetite for SCRIPs

Insurers that underwrite SCRIPs could be deemed by ASIC to be engaging in unconscionable conduct and, as a result, many add-on insurers have pulled out of the SCRIP market.

Even if ASIC has no particular legal basis to penalise an insurer for underwriting SCRIP business, many insurers may feel ASIC will take a dim view of this activity and perhaps ratchet up their "regulatory intensity" in other areas of the insurer's business.

This may help explain the declining availability of SCRIPs for dealers. The recent backflip by ASIC (per section 2.6 above) may reverse this situation if consumers do not wise up.

Tax advantage of Service Contracts

Note also

- If the Service Contract is not insured via a SCRIP, the cost to the consumer is $1,600 plus GST (i.e. no Stamp Duty, as there is no insurance)
- If the liability component of the Service Contract fee is insured via a SCRIP, the cost is $1,600 plus GST plus only half the usual Stamp Duty (in this example)

so there exists a further embedded incentive to sell Service Contracts instead of insurance warranty, courtesy of Australian tax laws (i.e., saving most consumers 5% - 10% of the premium in taxes).

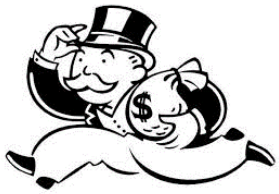
Dealers undoubtedly tell consumers about this "tax saving" as part of the sales pitch for Service Contracts.

Not that this "tax saving" will anywhere near compensate consumers for the extra ~~commission~~ dealer margin they will have paid in the Service Contract fee.

All the above "trickery" relies on consumers not knowing the difference between inclusion and exclusion warranty, and not understanding why insurance products inevitably provide superior value overall.

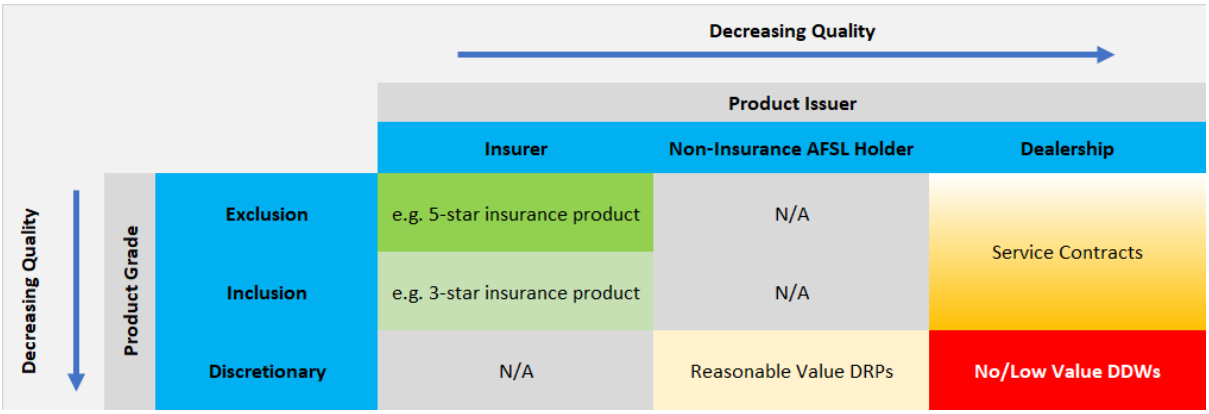
It isn't clear to me that anyone at ASIC, or elsewhere in the Australian regulatory landscape, is really giving due attention to all the above "regulatory arbitrage" even though, yet again, it provides an example of where dealers (and possibly their insurers) are incentivised to "do the wrong thing" by inadequate rules and regulations.

There is nothing new about "regulatory arbitrage".



Summary of product types and issuer types

The following schematic summarises the various options for "auto warranty" products in Australia



NB

While a non-insurance AFSL holder can only *issue* DRPs (on their own paper), they are often also *distributors* of insurers' products.

Auto-warranty product quality is driven by

- Coverage (exclusion warranty is best)
- Service quality (those signed up to the GICOP should be best)
- Security for issuer's claims obligations (insurance is best)
- Access to bespoke, industry consistent, dispute resolution (AFSL-licensed issuers are best - which includes insurers)
- Value for money
    - the lower the commission or other equivalent loadings, and the higher the published earned loss ratio, the better
    - Risk-rated premiums guard against low-risk vehicles subsidising high-risk vehicles
- How well the product segment is regulated (insurance is best)

The ACL provides coverage – a warranty is paying twice for cover consumers already have

This assertion may have had plausibility when most manufacturers offered 3-year/60,000 kms warranties and a 4-5-year-old vehicle had major issues. However, over the past 2-3 years, manufacturers have come round to the view that manufacturer warranties need to be longer, undoubtedly with encouragement from the ACCC and ASIC.

Most manufacturers now offer *at least* a 5-year/100,000 kms warranty and many offer more coverage, either on selected vehicles, or across their entire range.

For example

- 5-year/250,000 kms (or unlimited kms)
- 7-year/150,000 kms
- 10-year/200,000 kms

A handful of luxury marques have failed to match the new industry minimum standard of 5 years.

Based on my investigations, I was unable to find any other developed country, apart from New Zealand, where global vehicle manufacturers were offering warranties on the same or similar new vehicles, for the same or greater duration, as they are in Australia and New Zealand.

Furthermore, in Part 5 of the draft PIO "Product Intervention - Add-on Motor Vehicle Financial Risk Products"[16], (now withdrawn) ASIC effectively defined where in the life of a vehicle an extended warranty product could be issued by an ASIC-regulated entity.

In broad terms, if the vehicle is "almost" out of the manufacturer warranty (i.e., less than 10,000 kms, less than 12-months, etc.), or already out, then an extended warranty product can be sold, so long as there is no overlap in coverage under the manufacturer warranty and a host of other requirements are met, such as

- Claim cap at least $2k
- No requirement to have vehicle serviced within the selling dealer's franchised network
- For vehicle under 10 years old, no servicing requirements more onerous than the manufacturer's requirements for the vehicle, etc.

In light of the above, it would appear there was implicit regulatory messaging from ASIC that the degree of overlap between any remaining consumer rights under the ACL, and those provided under an extended warranty product that meets ASIC's new requirements set out in the draft PIO, are not significant enough to prevent the sale of a warranty.

This was a great example of where ASIC could have removed the blurry subjectivity typically associated with the ACL and clearly demarcated where an extended warranty can and cannot be sold.

Warranty myths busted

With "auto-warranty" products, there are a wide range of

- product types
- product issuers
- applicable laws and regulations (depending on who the issuer is)
- inherent protections and recourse for consumers with valid claims

Some products are good, some are definitely not.

[16] https://download.asic.gov.au/media/5727508/20-179mr-attachment-3-draft-order-tracked-version.pdf

Choosing a risk-rated, exclusion (or inclusion) insurance warranty product with modest incentive loadings will provide good value for money to consumers.

DDWs should be avoided and it is important to understand any inherent limitations in other non-insurance products such as DRPs and Service Contracts, to avoid unwanted surprises.

It is not yet clear whether ASIC will ever get jurisdiction over Service Contracts (and especially DDWs) and/or whether the existing regulatory arbitrage opportunities will be eliminated.

Nevertheless, along with ASIC's Product Intervention Powers (PIP), it seems that most of the regulatory infrastructure for reasonably effective oversight of "auto warranty" sales (that are financial products) is now in place.

So what is realistic?

In my view, risk-rated, extended warranty **insurance** products (or any add-on insurance products for that matter), with loss ratios of about 40%, and incentive payments capped at around 20% of premium, means

- All consumers get reasonable value for money products (and access to IDR/EDR)
- Dealers get a reasonable level of income from selling the products, to help them stay in business (and keep selling vehicles at low margins)
- Insurers and their operational partners get sufficient residual premium to pay claims, meet expenses, and service capital

Sounds like a remedy for a post-COVID world to me.

What about those Service Contracts?

If the regulatory arbitrage related to Service Contracts is not dealt with by law and regulation changes (ASIC cannot impose "dealer margin" caps on non-financial products they do not regulate), many dealers will continue to favour Service Contracts over Insurance Warranty because the incentive loadings for dealers in Service Contract fees are so much higher.

As noted above, it would be a foolhardy insurer that dealt in SCRIPs - this would likely invite heavy bouts of "regulatory intensity" from ASIC in all other areas of the insurer's business. It might also invite the wrong sort of attention from APRA, D&O insurers, investors and others who do not want to be associated with the bad reputation the insurer will inevitably be getting.

So dealers selling Service Contracts will probably have to carry all the uncertain repair cost risk themselves - something they do not specialise in. Consequently, the only remaining strategy with putting consumers off Service Contracts is to educate them.

Consumers must be informed, by all available means, that they

- Will be paying well over the odds for equivalent or lesser coverage
- Will not get a risk-rated premium (so low risk vehicles will subsidise high risk vehicles)
- Have little or no security that the dealer will be able to pay claims as they fall due
- Will not have access to bespoke, industry consistent internal and external dispute resolution services when claims get denied or reduced
- Cannot expect anywhere near the same service quality from a dealer (or their TPA)

Consumers going to car dealerships need to "learn the ropes" and stop being "wood ducks".

3.2 GAP is junk insurance

GAP Insurance pays the difference between the outstanding finance balance (including any financier exit fees and charges) and the payout from a comprehensive MVI insurer following a total loss event.

To say this product has "no value" across the board is false.

GAP is unlikely to have much, if any, value when a consumer

- makes a sizeable deposit, and the financier does not charge significant penalty interest
- already has an insurance policy that provides similar or materially overlapping coverage
- arranges finance over 12 - 24 months (and how many do this?)
- buys a GAP product designed for much larger (or smaller) finance amounts

I'm not saying that GAP wasn't sold under those circumstances but there were, and still are, add-on insurers out there for whom these sorts of outcomes were not as common as they were for the worst offenders.

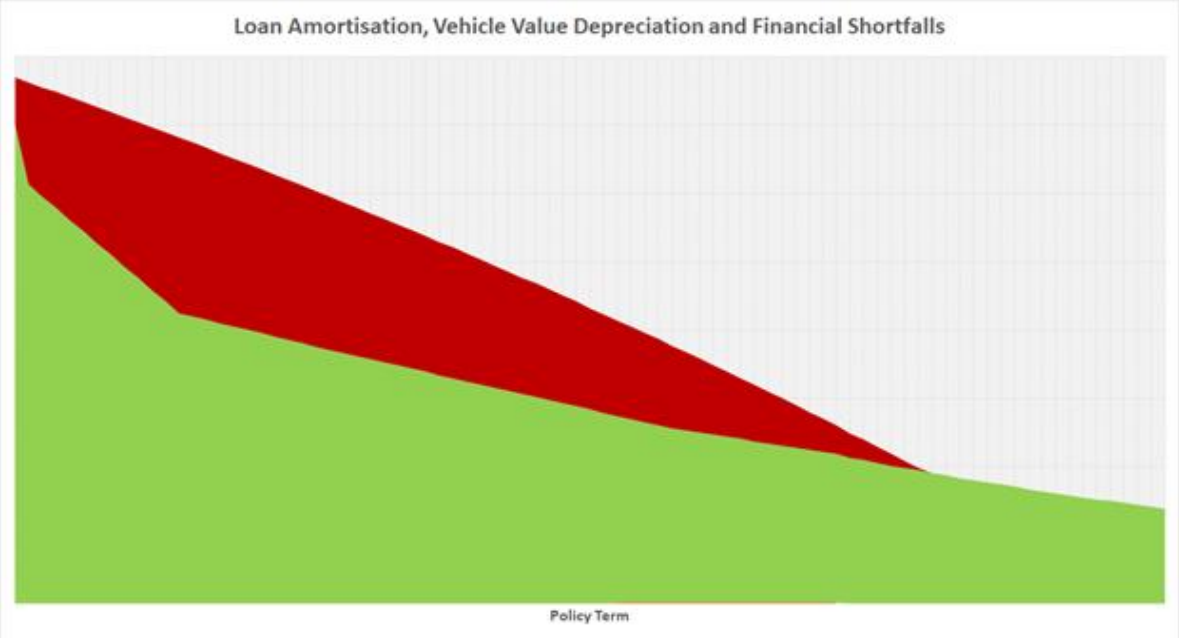
In my personal experience, the "typical" consumer finances

- over 110% of the Vehicle Purchase Price (i.e., the LVR > 110%)
- over a term of 60 months or more

and will therefore almost certainly get value from a properly formulated GAP (or similar) product.

By "properly formulated" I mean the benefits provided are a good match for the likely shortfall (and other losses) a given GAP consumer will face and the premium charged is proportionate to that risk exposure.

The following chart illustrates the risk exposure under a GAP policy



The **top** of the **red** area represents the amortisation of the financed amount over the policy term. In this example, this consumer borrowed around 110% of the vehicle purchase price. Once a finance contract is signed, this loan amortisation schedule is locked in and fixed.

The **top** of the **green** area represents the depreciation in vehicle value over time (and hence is a reasonable proxy for any subsequent total loss payout from a market value comprehensive MVI policy).

The **height** of the **red** area, at each point in time, represents the forecast shortfall under this particular deterministic depreciation scenario.

Under this particular depreciation scenario, the consumer is forecast to achieve equity at around 80% of the way through the contract (i.e., when the red area vanishes). That is, for the

first 80% or so of the policy/finance term, the consumer would receive less than the outstanding finance balance as a total loss payout from a market value comprehensive MVI policy.

There are several key things to note here

- the most common reason why consumers borrow over 110% of the vehicle purchase price is because they trade in an existing vehicle that is in a negative equity position (i.e., "upside down"). That existing negative equity is refinanced (i.e., rolled over) into the new vehicle's finance contract when the previous vehicle is traded in for less than the outstanding finance
- given the consumer borrowed 110% of the vehicle purchase price, this is a consumer who presumably does not have an abundance of spare cash available (otherwise, they would have borrowed less or paid a deposit, if they are/were rational)
- The size of the shortfall will vary according to the vehicle purchase price, but if the vehicle is purchased for (say) $35k over 60 months at 8% per annum, the shortfall will be over $5k for most of the first 30 months (and over $10k at its peak) and a person with limited spare cash (per the previous bullet) will most likely struggle to get ready access to cash sums in the range $5k - $10k
- If the consumer does have a total loss, they may also
    - Have an excess to pay on their comprehensive MVI policy
    - Incur stamp duty buying a replacement vehicle (which also needs to be insured)
    - Need to replace items in or on the vehicle that were stolen and/or damaged
    - Have incurred accommodation costs if the total loss event was far from home

  These items could add a further $2k - $3k in losses
- The depreciation scenario depicted above is just one of many conceivable scenarios - the actual realised depreciation scenario for a given policy will depend on many factors such as
    - how well the policyholder treats and maintains their vehicle
    - how many kms the policyholder travels
    - prevailing economic conditions
    - changes in popularity of their vehicle
    - etc.

  There is no guarantee that any given policy will achieve equity at any particular point in the life of a GAP contract.
- Furthermore, risk-rated GAP pricing takes note of the size of the "red" exposure area (as above) and prices accordingly. All else equal
    - Longer finance/policy terms should command higher premiums
    - Higher LVRs should command higher premiums
    - Finance contracts amortising to a residual (> $0) should command a higher premium
    - etc.

The last two major bullet points (and sub-points) specifically deal to a secondary GAP myth that says

"consumers are being ripped off in the last [20%] of the term as there is no risk exposure left"

Under properly formulated, risk-rated pricing, they were never charged for "the last 20% of the policy term" in the first place, so there is no over-charging.

Furthermore, the Additional Benefits can still be paid in the back end of a GAP policy term, even if there is little or no remaining shortfall risk.

Risk-rated pricing ensures that each policyholder is charged a premium proportionate to their expected policy lifetime risk exposure, as befits their particular vehicle purchase price, LVR, interest rate, exit fees, finance term and residual.

Naturally, it would also be possible to risk rate on policyholder age as younger (and older) drivers have higher total loss risk than intermediate aged drivers.

So long as the premium charged to each consumer is proportional to their risk of shortfall exposure (and any other benefits they would receive following a total loss), GAP insurance is a perfectly viable, reasonable, and valid product.

Following ASIC's investigations (and insurers' remediations) many insurers now have "LVR knock-out" tests, meaning any consumer with a reasonable deposit will not even be offered GAP insurance.

Hail events

Ironically, the negative publicity surrounding add-on insurance, and GAP insurance specifically, meant that by early 2020, many financed vehicle owners in Australia did not have GAP (or similar) insurance.

Subsequently, the severe hailstorm events impacting Melbourne, Canberra, and Sydney in January 2020, led to two distinct classes of financed vehicle owners:

- those with GAP
- those without GAP

3.3 Summary

Not all add-on products are created equal.

Some products are of good quality and, in my opinion, some are among the poorest quality of any consumable product available in Australia today.

Moreover, in the minds of consumers, consumer advocates and the media, a lot of what is classified as "junk insurance" is oftentimes not even **insurance** at all.

There is very little understanding and appreciation of the wide differences in products and issuers (and their regulators, if any) across the various markets.

As a result, a number of "myths" have been propagated that tar all add-on products with the same brush.

ASIC does not even have jurisdiction over some add-on products - namely Service Contracts (which includes Discretionary Dealer Warranty) because these products are exempt from the ASIC Act (2001) due to the "incidental product" exemption under section 763E of the Corporations Act (2001).

The existence of alternatives to insurance markets, with far less stringent rules and regulations, means unaware consumers still face the risk of purchasing these products, which often provide little in the way of security and benefits, few avenues for dispute resolution and very poor value for money.

These regulatory arbitrage "loopholes" need to be closed. But it is not ASIC's job to do this - it is the wider government's job.

Consumers, who remain confused and misinformed about these substantial differences in product quality, may continue to boycott or avoid good quality add-on products that could otherwise provide them with useful financial protection.

4. Identifying add-on insurers with poor products and services

Just as endless speed limit "lollipops" on the roadside do not guarantee safe roads, so new legislation and regulations can never guarantee that add-on markets will be free from products and sales processes that deliver "significant detriment" to consumers.

All stakeholders in add-on insurance markets need to play their respective parts and take proactive steps to evaluate the various add-on insurers and other issuers, their sales processes, products and services, and make their own determinations as to suitability for consumers.

ASIC did originally intend for automotive add-on insurers to regularly monitor, report on, and display publicly, the values of loss ratios, claim acceptance/decline rates and various other performance metrics.

Add-on insurers embracing the spirit of regulatory changes will no doubt display at least some of these metrics (proudly) on their website anyway, to demonstrate to all stakeholders that they are serious about transparency and putting consumers front and centre in the design and delivery of their products and services.

Those add-on insurers who, five years on from the 2016 ASIC reports, still generate shameful values of these metrics (e.g. add-on insurance loss ratios below 20%) will no doubt be vague and opaque about the display of such statistics. A lack of transparency and/or timeliness in their display (if at all) could be read as a signal that the add-on insurer has something to hide.

Some add-on insurers' key performance statistics (e.g. earned loss ratios) will also be readily discernible from their publicly available APRA general insurance statistics, if their business is predominantly add-on insurance. These can be compared directly to metrics displayed on their website (if any) and cross-checked for consistency.

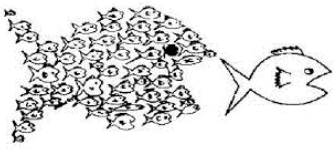
For insurers who write across many classes, it will be more difficult to cross-check their add-on performance metrics.

Not only are consumers and regulators (e.g. ASIC and APRA) going to be monitoring this sector closely but it also seems, based on recent activities, that

- Litigation funders and class action lawyers
- D&O insurers
- Potential shareholders/investors
- Consumer groups
- Product review and comparison websites

will also be taking an active interest in the ongoing performance and transparency of individual add-on insurers and taking appropriate actions in response to what they observe.

The add-on insurance stakeholder group therefore has a wide base of interests.



Trade-off between delivering value to policyholders versus delivering value to shareholders

It barely needs emphasising that driving loss ratios higher [lower] means profitability deteriorates [improves].

Add-on insurers cannot afford to be too heavily biased in either direction

- If an add-on insurer goes too hard on raising loss ratios (e.g., to appease ASIC and to entice consumers, or to discourage litigation activity) it may end up with a profitability problem (which could be concerning for both APRA and investors/shareholders)
- If an add-on insurer goes too hard on raising profitability (e.g., to satisfy APRA and/or investors/shareholders) it may end up with a "value" problem (e.g., add-on insurance loss ratios too low) which could lead to consequences such as
    - ASIC exercising its Product Intervention Powers
    - Litigators taking an interest in a potential class action
    - Adverse publicity from consumer groups
    - Increasingly aware consumers boycotting the insurer's products

Regardless, any add-on insurer with a whiff of ongoing controversy, will likely attract the ire of ASIC, APRA, litigators and consumer groups and this in turn could see the limitation and/or withdrawal of

- D&O coverage for the insurer
- The insurer's freedom to operate as they see fit (e.g. APRA and/or ASIC licencing restrictions)
- Investment/shareholding in the insurer

In my view

- If all stakeholders play their respective parts effectively, this will evolve into a market with nowhere for a dodgy operator to hide
- There is little point condemning dealers for bad behaviour; as some might say, that's like blaming snakes for having fangs. **All** the above stakeholders need to perform their roles so that the bad products and their dodgy providers pack up and move on (for keeps)
- The only winners will be consumers and those add-on insurers that embrace the new regulatory environment and its challenge to do much better by their customers

Drain the swamp.

5. Wrap Up

As an actuary, who

- worked at an add-on insurer for nearly 5 years
- was heavily involved in the add-on insurance remediation process with ASIC
- was (and is) heavily involved in re-constructing and re-pricing add-on products

I am of the firm view that there is nothing inherently wrong with add-on insurance products sold at car dealerships, through salary packaging entities, through automotive brokers and vehicle auction houses.

In general, add-on insurance products can generally be expected to be superior to similarly specified non-insurance products, because of

- the financial security of insurers having to comply with APRA's solvency requirements
- product and conduct standards imposed by ASIC and the ICA
- controls over commissions and risk-rated premiums
- access to bespoke dispute resolution services

However, if you overload **any** product with incentive payments ("batter, fat and sugar") and exercise little regulation or oversight over sales and claims processes, then you will inevitably end up with severe conflicts of interest on the part of the product sellers and get poor outcomes for consumers.

Furthermore, if you have largely community-rated products, so that "good" risks subsidise "bad" risks, these poor outcomes will be especially concentrated among "good" risks; arguably the risks who least deserve this outcome.

Lastly, and by no means least, if the design and distribution of these products is clear and transparent, low pressure, and meets the needs of a well-defined target market, then consumers should have sufficient time and space to properly evaluate whether a given product is right for them and their circumstances.

		AFSL Licensed		Service Contract	
Theme	**Positive Feature**	**Insurance**	**DRP**	**Non-DDW**	**DDW**
Financial Security	Regulated by APRA	√	X	X	X
	Very high security for claims obligations	√	?	?	X
Treating Customers Fairly	Regulated by ASIC	√	√	X	X
	Access to industry consistent IDR and EDR processes	√	√	X	X
	Issuer subject to GI Code of Practice (Service Quality)	√	√	X	X
	Controls/Caps for Incentive Loadings in Premiums/Fees	√	√	X	X
	Adequate Product Information Provided (PDS, FSG, TMD etc.)	√	√	X	X
Value For Money	High Levels of Coverage Available	√	?	?	X
	Risk-Rated Premium Rates (to minimise cross-subsidisation)	√	?	X	X
	Premium refunds available on cancellation	√	√	X	X

In the past 4-5 years there have been many investigations into this segment and now a raft of reforms which should rightly go a long way towards restoring consumer (and regulator) confidence in these products and their distribution.

But, in my view, there is still much to do

- Simplify the "road rules" with clear boundaries between right and wrong
- Get rid of the "regulatory arbitrage" opportunities - close the loopholes. Only lawmakers and regulators can get that done
- **Educate consumers about variations and differences between products** with the same or similar sounding names so they know the products to seek out (and from whom) and

the products and issuers to avoid (just in case lawmakers and regulators don't do their job and get rid of regulatory arbitrage - hard to imagine, I know)

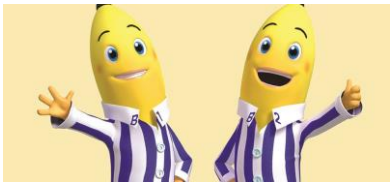
- Raise awareness of any ongoing issues so that the actions of litigation funders, class action lawyers, investors, D&O insurers, regulators, consumer groups and indeed consumers drive positive change

Metaphorically, just don't batter and deep fry your banana and then coat it in sugar when it rolls out of the basket.

There are so many other healthier ways to "serve your banana" that are indeed wholesome and helpful to your target market.

Hopefully, this paper has helped you understand why only "deep fried bananas" were served previously and how insurers now have the opportunity to better meet consumers' needs, with healthier offerings in a reformed, better-policed environment and why, without appropriate regulatory intervention, consumers will still get served "deep fried bananas" - just out of the back of a van, rather than from a regulated shop…

It's time to split…



6. Disclaimer

The views and opinions expressed in this paper are those of the author alone and do not necessarily reflect the views of the author's current or previous employers.

While the paper has been formally and informally reviewed, any remaining errors or factual inaccuracies are the responsibility of the author.

7. Acknowledgements

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Appendix A A brief description of add-on products

A.1 Extended Warranty

Many people are familiar with warranty products, whether it be for automobiles, whitegoods or other electronic goods.

The essential function of a Warranty insurance product is to cover the costs of repairs to the good and restore the good to normal functionality at no charge (other than the original premium).

There can be excesses and caps to manage claims costs (and premium rates) down.

In general, automotive extended warranty products do not have excesses (i.e. deductibles) but in some cases there may be claim caps. This is discussed in some detail in section 3.1 of this paper.

While there may be some price differentiation in the market for different vehicles, in many cases, pricing is still heavily community-rated, meaning cross-subsidisation (and anti-selection) are big issues for add-on insurers that do not risk rate.

The difference in warranty risk cost between

- a small, basic Japanese FWD vehicle with low kms
- a large, high performance, European 4WD with higher kms

both buying a [24-month] warranty, could be a factor of 20.

That is, the ageing, tech-heavy Euro-banger could be expected to cost 20 times as much as to repair in any given timeframe as the zippy, little Japanese "shopping basket".

The body of this paper has discussed issues of coverage and any overlap with rights under Australian Consumer Law (ACL).

A.2 GAP

Section 3.2 of this paper provides a reasonable overview of GAP risk.

Traditional GAP products are linked directly to a finance contract. The GAP policy will generally have exactly the same term as the finance contract it relates to and, as noted in section 3.2, the primary purpose of GAP products is to protect consumers from the scenario where the payout from a comprehensive motor insurance policy is insufficient to clear the outstanding finance balance, following a total loss event (e.g., a major collision, unrecovered theft, severe hail damage, fire, and full immersion flooding).

GAP products also pay "additional benefits". These are generally intended to deal with out-of-pocket expenses relating to the total loss event such as

- damage or loss of goods stored in or on the vehicle
- comprehensive motor insurance policy excesses
- Stamp Duty, registration costs and insurance premiums for a replacement vehicle
- accommodation costs if the total loss event occurred far from home
- etc.

Many traditional GAP products have a policy limit to the shortfall benefit (e.g. $15k) and often the additional benefit grows in proportion to the maximum shortfall benefit.

Consequently, common community-rated traditional GAP product variants are

- "$10k/$2k GAP" (which covers shortfalls up to $10k and additional benefits up to $2k)
- "$15k/$4k GAP" (which covers shortfalls up to $15k and additional benefits up to $4k)
- "$30k/$10k GAP" (which covers shortfalls up to $30k and additional benefits up to $10k)

Naturally, the higher the cover level the greater the community-rated premium but it is common for there to be no variation in premium rates by

- Policy term - longer term loans have greater shortfall exposure than shorter term loans
- Loan to Value Ratio (LVR) – a high LVR loan on a given vehicle will cost substantially more than a low LVR loan on the same vehicle, over the same term
- The existence of a balloon payment (which raises shortfall exposure)

Furthermore, there is an implicit need for the correct level of cover to be matched to the circumstances of a given policyholder. This has caused many issues, such as

- Consumers borrowing $9k to buy a $10k vehicle and being sold a $30k/$10k GAP
- Consumer borrowing $60k to buy a $50k vehicle being sold a $10k/$2k GAP
- Consumers borrowing $10k to buy a $20k vehicle being sold any GAP product at all

The "reasons" for these sorts of poor outcomes were various.

GAP product variations

There are also variations on the traditional GAP product and one common variant is Return To Invoice (RTI), also known as Purchase Price GAP.

An RTI policy is somewhat simpler than a traditional GAP policy in that

- it is not linked to a finance contract
- following a total loss event, it pays the difference between the comprehensive insurer's total loss payout and the original purchase price of the vehicle (the "invoice" price) when the RTI policy was also purchased

Confusingly, RTI is sold in the United Kingdom as "GAP".

Many insurers now offer "hybrids" of traditional GAP and RTI so that the consumer can receive

- the RTI shortfall benefit earlier in the policy term (e.g. the first 36 months)
- The traditional GAP shortfall benefit later in the policy term

The hybrid approach is a simple way to ensure every consumer gets "value" from the product as the RTI benefit applies regardless of the size of any finance shortfall.

Pricing and value

As noted above, GAP and its variants are often subject to community-rated pricing despite there being wide differences in the risk profiles of different policies.

What this means is, an add-on insurer who satisfies reasonable expectations at the portfolio level (e.g. a loss ratio of 40%) may have much poorer outcomes at the individual consumer level.

It is not inconceivable for two [GAP] policyholders to buy a community-rated product that has

- A 10% expected loss ratio for one customer (e.g. a lower LVR, 36-month term)
- An 80% expected loss ratio for another customer (e.g. a higher LVR, 84-month term)

in a pool which averages a loss ratio of 40% per customer.

A.3 Consumer Credit

Consumer Credit Insurance (CCI) generally cover consumers for (at least)

- Morbidity (i.e. accident and sickness, including mental illness)
- Involuntary redundancy (but only for the permanently employed, working > 20 hours pw)

In general, access to CCI benefits commences after a "wait period"; commonly this would be 14 - 30 days.

The CCI benefit is coverage of the automotive finance repayment during any period of morbidity and/or involuntary redundancy.

CCI therefore has some similarities to Disability Income Insurance (DII), except that instead of providing [75%] of pre-injury income (DII) it would cover 100% of the automotive loan payments (CCI).

The CCI benefit periods are also often capped, with typical caps being

- 36 months for morbidity
- 6-9 months for involuntary unemployment

There may also be some aggregate dollar benefit limits (which might mean a CCI policy with high monthly loan repayments might not be able to achieve the full 36 months' morbidity cover).

Eligibility requirements for CCI would generally be (at least)

- Limited to the policyholder being no older than 67 years of age at the end of the policy term
- Must be in a permanent employment position (typically > 20 hours per week) and have been in continuous employment for a period prior to policy commencement (typically 12 months)

Exclusions would apply for (at least)

- Pre-existing medical conditions
- Pregnancy-related issues (including complications with IVF etc.)
- Deliberate self-harm
- Ignoring the advice of a registered medical practitioner
- World Health Organisation declared pandemics

As usual, many insurers offer products with a significant degree of community rating but, notably, CCI is generally rated by policy term (longer terms attract higher premium rates) and the rates are usually per $100/$1,000 of the financed amount.

As noted in the body of this paper, CCI is also covered under NCCP legislation, and actuarial items of note under the NCCP Act include

- A mandated cap on commissions of 20% of premium (excluding government charges)
- A mandated "Rule of 78" premium refund formula for early cancellations

CCI Variants

The most common variation on the above "standard" CCI product is Loan Termination Insurance (LTI).

LTI is a bit like a hybrid between traditional GAP and standard CCI.

The trigger events for LTI claims are as for CCI (i.e. morbidity and involuntary unemployment) but the benefits are somewhat different.

LTI allows the policyholder to hand back their vehicle to the dealership where they purchased the vehicle and the LTI policy pays any shortfall between what the dealership pays for the vehicle[17] and the outstanding finance balance. This is conceptually similar to the GAP shortfall.

LTI products also include an additional benefit which consists of some number of loan repayments.

However, the more limited period of loan repayment benefits (generally 6 - 12 months only) acts as a "first line of defence" to full vehicle handback and gives the policyholder an opportunity to recover from their morbidity and/or find new employment.

LTI is generally cheaper than CCI because of the shorter loan repayment benefit period.

A.4 Tyre & Wheel

Tyre and Wheel Insurance (TWI) is a low premium (often < $200), annually renewable product that typically plays out below the excess on a comprehensive motor insurance policy.

TWI covers punctures and structural damage caused to tyres and wheels as a result of road and driving hazards (e.g. potholes).

However, TWI does not cover cosmetic damage, such as scratches to rims caused by parking too close to the gutter, unless the rims are also structurally damaged.

It is also a requirement of TWI that the tyres be roadworthy at the time of any claim. TWI does not apply to tyres that simply wear out.

As usual, many add-on insurers apply little, if any, risk rating and it is not uncommon to find the same or similar TWI premium being charged for high profile, small diameter/width cheap tyres (and steel rims with nasty plastic hubcaps) as are charged for low profile, wide, large diameter expensive tyres (on nice shiny alloy rims).

[17] Often subject to price floors at wholesale (i.e. "trade") values defined by Glass's Guide or Redbook vehicle data