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Replacing life insurance — who benefits?

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Executive summary

Purpose of this report

In the year to June 2014, New Zealand consumers spent $1.7 billion[1] on annual premiums for life insurance policies. Just under half of these policies were sold through financial advisers, and a significant percentage were shifted during the year from one insurance provider to another.

We have previously raised concerns about the extent of replacement business in the life insurance industry. Replacing one insurance policy with another can be in a consumer's best interest. However, if the move is driven by what the adviser will earn in incentives and commission, and there is no clear benefit to the consumer, it is known as 'churn'.

Our concerns about insurance churn, and the harm it can cause, align with four of the seven strategic priorities we outlined in our *Strategic Risk Outlook 2015.* They are:

- governance and culture
- conflicted conduct
- sales and advice
- investor decision-making.

In May 2015 we requested four years of data from the 12 main insurance providers in New Zealand, under section 25 of the *Financial Markets Authority Act 2011* (FMA Act). The data was from April 2011 to March 2015 and included four types of cover: life, trauma, income protection, and total and permanent disability (TPD).

The Australian Securities and Investment Commission (ASIC) published its own report on retail life insurance advice in October 2014. Two more reports were published on the issue in 2015: the Trowbridge report in Australia, and the Melville Jessup Weaver report in New Zealand.

Our review differs from these reports because it is solely focused on replacement business. It only considers authorised financial advisers (AFAs) and registered financial advisers (RFAs), because there is a higher risk of churn in this group. This is because they generally sell more than one brand of life insurance. Other types of advisers could still be mis-selling but because they only sell one brand, they are unlikely to be churning policies.

The reason we are concerned about insurance churn is because:

- there is a risk consumers could have claims denied that might have been accepted under their original policies
- by replacing policies, consumers could lose benefits they might have received under their original policies
- policies that are cheaper in the short term can be far more expensive in the long term
- consumers could be over-insured, or under-insured, because of poor advice.

Of wider concern is the possibility that New Zealanders are paying too much for life insurance, because insurance providers are spending too much on commissions to advisers due to churn. In a report published last month, the NZ Institute of Economic Research[2] calculated that life insurers are spending around $430 million a year on commissions. The report suggested that if this were reduced by half, premiums could be cut by up to 12%.

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[1] Based on the four types of life cover included in this review. For more comprehensive data, see the industry statistics collated by the Financial Services Council, which are available on its website.
[2] The report, *Resetting Life Insurance*, was commissioned by Sovereign Assurance.

What we found

There are approximately 8,200 AFAs and RFAs in New Zealand. Of these, about 4,500 do not have any active life insurance policies on their books. Another 3,700 have at least one active policy and were therefore included in this review.

Any RFA or AFA who sells life insurance could potentially churn policies. However, we took a particular interest in the following group:

1,100	AFAs and RFAs with more than 100 active life insurance policies on their books ('high-volume' advisers)
200	'High-volume' advisers who also had a high rate of replacement business ('high-replacement' advisers)

To best use our resources, we have focused on the advisers who deal with the largest number of consumers. Within this group, the 200 'high-replacement' advisers are most likely to have the largest number of consumers whose policies have been churned. In 2014, these advisers had 65,000 active life policies between them, paying around $110 million in annual premiums. We acknowledge that some may be doing a great job for consumers, and it is possible only a small proportion may be churning policies.

Our analysis also showed:

- The overall number of life insurance policies grew at under 2% each year[3] during the review period. However, in each year life insurers described 11% to 13% of their policies as 'new'. This shows that many 'new' policies were more likely to be replacement policies.
- There was a strong link between types of commissions, the end of the clawback period (the period within which an adviser must repay a portion of their commission if the policy is cancelled), and the likelihood of a policy being replaced. Policies with a high upfront commission were more likely to be replaced once the clawback period ended.
- The quality of a policy (known in the industry as a 'product score') was only a minor factor in whether a policy was replaced. This suggests that some advisers are acting in their own interest, rather than in consumers' best interests.
- Overseas trips appear to be an effective sales incentive for advisers. Policies no longer subject to clawback were 2.2 times more likely to be replaced if overseas trips were offered as an incentive. Even new policies still subject to clawback were 8% more likely to be replaced if an overseas trip was offered.
- During the review period, advisers were offered trips to destinations such as Shanghai, Prague, Las Vegas, Hollywood, Rome, New York and Rio de Janeiro as sales incentives by life insurers. The high-replacement advisers took an average of two of these trips each. One high-replacement adviser took 10 trips in four years.
- On average, RFAs had higher rates of replacement business than AFAs. About two-thirds of the high-volume advisers, and 86% of the high-replacement advisers, were RFAs. Some RFAs replaced more than 35% of their life policies in one year.
- On average, the high-replacement advisers earned almost 50% more from commissions on life insurance than other high-volume advisers.
- Around half of all advisers earned less than the minimum wage in commissions from life policies in 2014. These advisers may have other sources of income. However, some advisers earned significant income from life insurance commissions. Around 150 advisers (4%) earned at least $200,000 in 2014, and around 70 advisers (2%) earned at least $300,000.

[3] According to data provided to us by life insurers. Financial Services Council data shows the value of policies is growing at under 6% pa, which includes premium increases.

Action we are taking

As a result of this review, we have already met with life insurers and adviser associations to discuss our findings. Our other actions include:

- We are working with insurance providers and the Financial Services Council to consider how they could address potential risk to consumers.
- We will monitor advisers, and carry out site visits where we have identified particular issues. In particular, we will visit advisers with high rates of replacement business to review their practices and examine whether churn is occurring. If we believe a financial adviser has breached their statutory duties of due care, skill, and diligence, we can take action under the *Financial Advisers Act 2008* (FA Act). If we believe an AFA has breached the code of professional conduct, we can refer the case to the Financial Advisers Disciplinary Committee (FADC).
- We have provided our findings to the Ministry of Business, Innovation and Employment (MBIE), which is currently reviewing the FA Act. The review is examining issues such as conflicts of interest, licensing and disclosure.
- We will produce further guidance for financial advisers on how to ensure they are putting their customers at the heart of what they do.
- We have developed further resources for consumers to help them to make better-informed decisions when buying or replacing life insurance.
- We will also share relevant information with the Council of Financial Regulators, which co-ordinates financial regulation across government agencies. The council includes the Reserve Bank, the FMA, the Treasury, and MBIE.

Our role

Financial advisers and salespeople are regulated by various laws, including the FA Act. Under this Act, which is currently being reviewed, the range of financial advice that an adviser can give is limited by whether the individual is an AFA, an RFA, or a QFE adviser. All three classes of adviser can give personalised advice about life insurance, even though this advice is subject to different regulatory obligations depending on the status of the adviser.

- QFE advisers —are not required to be individually registered, and are generally employed by large organisations such as banks to sell their own products. They can give personalised advice on life insurance, but not as part of an investment planning service.
- RFAs — must register with the Registrar of Financial Service Providers, but are not required to meet the same standard as AFAs, such as minimum education requirements. They can give personalised advice on life insurance, but not on more complex products such as KiwiSaver, bonds, shares, managed funds and derivatives.
- AFAs — individually authorised by the FMA to give personalised advice on most types of investment products, including life insurance, as well as more complex products. They are required to abide by a code of professional conduct, including minimum education requirements. The code includes a requirement to act in the best interest of consumers at all times, and to avoid situations where the interests of the adviser conflict with the interests of the consumer. We must refer breaches of the code to the FADC, which considers disciplinary action.

The FA Act allows the FMA to take action if we believe an AFA or RFA has breached their statutory duties of due care, skill, and diligence. We can direct them to comply, and if they fail to do so there is a maximum fine of $5000. For misleading or deceptive conduct, an individual can be fined up to $100,000 and a business can be fined up to $300,000.

More recently, the *Financial Markets Conduct Act 2013* (FMC Act) brought in significant new conduct requirements. The new fair dealing provisions in the FMC Act prohibit misleading representations about financial products or services, including any representations about the need for products or services. Maximum civil penalties under this provision are $1 million for individuals or $5 million for a corporation.

This review is not intended to address the wider issue of remuneration in the industry. It is focused on adviser behaviour and whether that behaviour is harming consumers. It focuses on the behaviour of AFAs and RFAs because that is where churn is more likely to occur. While there is still the potential for mis-selling by other types of advisers and through direct sales, there is a lower risk of churn through these channels because they are focused on sales of their own brand.

Conflicts of interest are inherent in the sales structures of the insurance industry, and conflicts driven by financial adviser remuneration and incentives have been the subject of media attention, industry debate and FMA complaints in recent years. We have previously raised concerns about excessive replacement business in the industry. Our *Strategic Risk Outlook 2015* identified the mis-selling of financial products, including insurance churn, as one of our specific areas of focus.

In response to these concerns, we initiated a review to determine whether insurance churn exists in the New Zealand market and, if it does, whether it harms consumers. In May 2015 we requested a range of data covering a four-year period from 12 insurance providers under section 25 of the FMA Act. This included information about active and lapsed premiums and policies to 31 March 2015, as well as commissions paid by providers. It included life, trauma, TPD and income protection cover.

The life insurance industry in New Zealand

Advisers

Type of adviser	Approximate number in June 2015	What they do
QFE advisers	26,000	Employed by 56 large organisations such as banks and fund managers (known as Qualifying Financial Entities or QFEs) to sell their own products. They can give personalised advice on life insurance, but not as part of an investment planning service.
Registered financial advisers (RFAs)	6,400	Can give personalised advice on life insurance, but not on more complex products such as KiwiSaver, bonds, shares, managed funds and derivatives.
Authorised financial advisers (AFAs)	1,800	Individually authorised by the FMA to provide personalised advice on most types of financial products. Can also be licensed to provide investment planning services.

Providers

There are 12 major providers of life insurance in New Zealand. They use one of three main distribution methods to sell insurance to consumers:

- AFAs and RFAs
- Direct sales (including QFE advisers)
- A combination of financial advisers and direct sales.

Relationships between advisers and providers are governed by agency agreements. These agreements may be exclusive or non-exclusive, and may contain restrictions or quotas.

Advisers may be members of one or more fee-based adviser associations, such as the Professional Advisers Association, the Institute of Financial Advisers, or SiFA Incorporated. These associations provide benefits such as training courses, conferences, political advocacy and document templates.

Advisers may also be members of a dealer group. These groups provide similar services to adviser associations, but are funded by commissions on members' product sales. By aggregating sales, members may earn higher volume-based commission bonuses.

Policies

In June 2014, there were around 1 million active life policies among the 12 main providers. Less than half of these were sold by AFAs and RFAs. The rest were sold through direct channels such as banks, or other types of advisers that existed before the FA Act came into force.

How to buy life insurance in New Zealand

CONSUMERS

DIRECT SALES

Through a provider's own branch, phone service or website (eg AMP, ANZ/OnePath, BNZ Life, ASB, Sovereign, Cigna, Kiwi Insurance, Westpac, Pinnacle Life).

COMPARISON WEBSITES

Allow consumers to compare prices or buy policies. Receive commission from insurance companies (eg LifeDirect).

GROUP INSURANCE

Some organisations arrange group policies for their employees or members directly with insurance companies.

FINANCIAL ADVISERS

Receive commission from insurance companies (eg AIA, AMP, ANZ/OnePath, Fidelity Life, Asteron Life, Partners Life, Sovereign).

INSURANCE COMPANIES

Dealer groups

Provide services to advisers, and receive commission from insurers.

Adviser associations

Provide services such as training and conferences to advisers.

Research providers

Sell research to help advisers compare policies and prices.

Lead generators

Sell lists of potential customers to some advisers.

DISPUTE RESOLUTION SERVICES

Free service for consumers to resolve disputes with advisers and insurance companies (Insurance and Financial Services Ombudsman Scheme, Banking Ombudsman Scheme, Financial Services Complaints Ltd, Financial Dispute Resolution Scheme).

Distribution

The 12 major providers use different distribution models.

Company	Distribution model
AIA	AFA/RFA businesses
Asteron Life	AFA/RFA businesses, QFE advisers
Fidelity Life	AFA/RFA businesses
Partners Life	AFA/RFA businesses, QFE advisers
AMP	QFE advisers (employees, AFA/RFA contracted agents), direct sales, AFA/RFA businesses
ANZ/OnePath	QFE advisers, AFA/RFA businesses
Sovereign	Sovereign QFE advisers, AFA/RFA businesses, ASB QFE advisers
BNZ Life	QFE advisers, website sales
Kiwi Insurance	Kiwibank QFE advisers
Westpac	QFE advisers
Cigna	Telephone sales, QFE advisers
Pinnacle Life	Website sales

Commissions

When consumers buy life insurance through a financial adviser, the adviser receives up to four types of commission.

Commission type	How it's paid
Upfront	Paid on the initial sale.
Trail	Paid for every year the policy remains in force. If a consumer changes adviser, the original adviser usually continues to receive a trail commission unless the new adviser buys the client from the former adviser.
Bonus	Paid for meeting additional criteria, such as volume (number of policies sold) or persistency (the proportion of policies sold that do not lapse during a certain period).
'Soft'	Offered as an additional benefit. Examples include overseas trips, tickets to sporting events, small value gifts, training, software subsidies, business development and marketing grants, subsidised loans, event sponsorship, and paying registration fees.

Commission structures are broadly divided into three categories:

- **Upfront** — a high upfront commission for the first year's premium (sometimes as high as 200% of the annual premium, including bonus commission) and a lower trail (such as 5-7% of the annual premium) for each subsequent year
- **Hybrid** — a lower upfront commission (up to about 150% of the annual premium, including bonus commission) and a relatively higher trail (such as 10-12%)
- **Level** — upfront commission is roughly equal to trail commission (including bonus commission).

In New Zealand, upfront commission is the most common type. Hybrid and level commissions are far less common. However, hybrid commissions are increasing in popularity.

If an adviser is a member of a dealer group, the insurance company will also pay commission to the dealer group.

What is a 'clawback' period?

If a consumer cancels a policy within a specified 'clawback' period, which is usually two years, the adviser must repay a portion of the upfront commission to the insurance provider.

Some advisers charge this 'clawback' to the customer.

Types of cover

A life insurance policy can include different types of cover. In this review, we refer to four types of cover: life, trauma, income protection, and TPD. Some providers refer to these different types of cover as 'benefits' or 'riders'.

Different providers also use different terms. We have given some common examples below:

- **Life** — life insurance, death cover
- **Income protection** — temporary disability, sickness insurance, total temporary disability (TTD), mortgage cover, household expenses cover
- **Trauma** — critical Illness, crisis cover, serious condition, serious trauma, dread disease
- **TPD** — total and permanent disability, total and permanent disablement.

What we found

In this section, we have analysed all the data across the review period. However, in some cases our analysis provides a snapshot of the data in 2014, as this is the most recent data available and is most easily comparable on a full-year basis.

Replacement business

It is widely accepted by the insurance industry that it is easier to replace a consumer's existing policy than it is to sell new insurance. This is partly because it can be difficult to convince those who do not already have life insurance of the need for it.

Sometimes it is in a consumer's best interest to change policies. For example, the new policy may be better suited to the consumer, or may be cheaper. However, a high rate of replacement business suggests there may be churn, especially if it comes after the adviser's commission can no longer be clawed back by the initial insurance provider.

What we found:

During the review period:

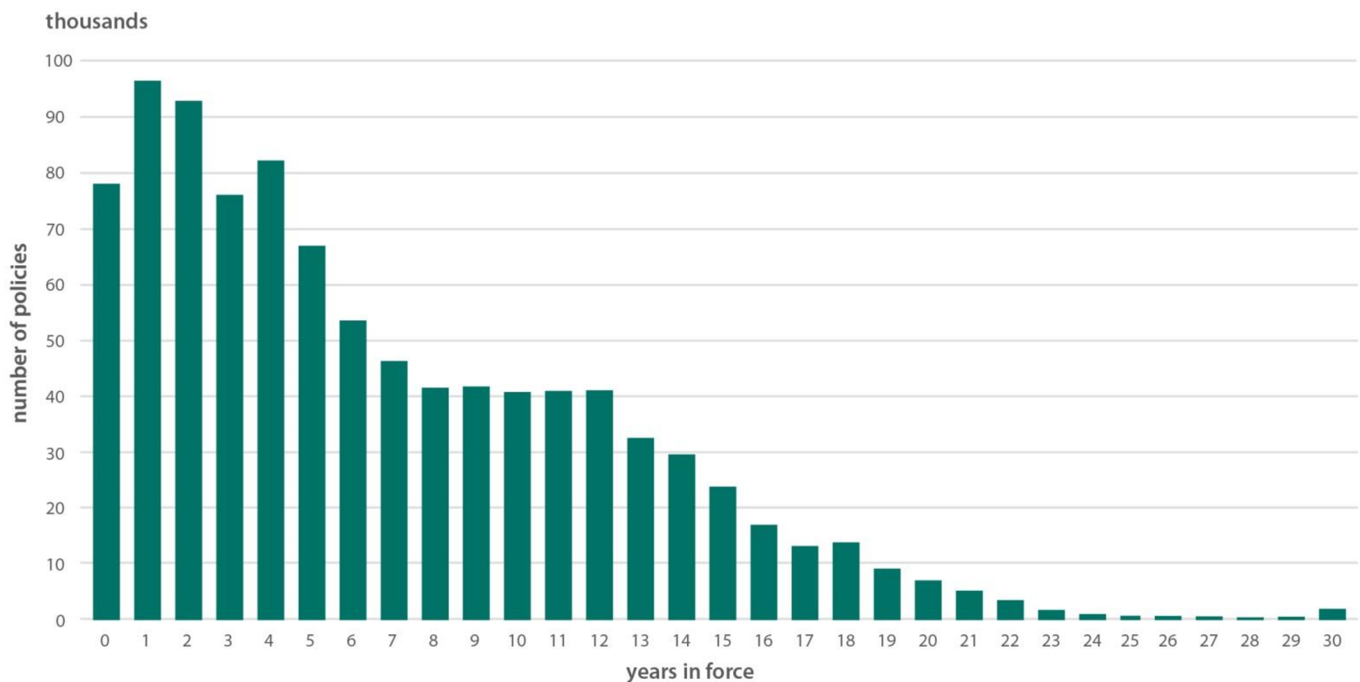
- According to data provided to us by life insurers, the number of life insurance policies grew at under 2% each year. However, in each year, these providers classified 11% to 13% of policies as 'new'. This shows that most 'new' policies were more likely to be replacement policies.
- Out of 1,100 advisers with more than 100 life policies on their books, around 200 met our criteria for a high estimated rate of replacement business (see the definition below). This group of advisers is at a higher risk of churning clients. In the year to June 2014, they had 65,000 active policies between them, totalling around $110 million in annual premiums.
- 45 high-volume advisers replaced more than 20% of their life policies in a single year, and nine replaced more than 30% of their policies in a single year.
- On average, RFAs had higher rates of replacement business than AFAs. In 2014, the median for RFAs was 7%, compared to 4% for AFAs.
- RFAs made up about two-thirds of the high-volume advisers, and 86% of the high-replacement advisers.

What is a 'high' rate of replacement business?
We define a 'high' rate as when:

- at least 12% of an adviser's policies lapsed, and the adviser writes at least 12% of policies as new business within one year, or
- at least 40 of an adviser's policies lapsed in a single month and the adviser writes at least 40 new policies in the same month.

Our estimate may include some customers who cancelled their policies, and some genuine new customers. Therefore it may overstate the replacement rate.

Age of life insurance policies (in June 2014)



More than a quarter of active life policies in June 2014 were less than three years old. The data suggests that most of these policies are likely to be replacement business.

Commissions

Our review shows a strong link between high upfront commissions and the likelihood of a policy being replaced. The type of commission was the most significant factor in whether a policy was replaced. The next most important factor was whether the clawback period had ended, followed by the age of the policy. The quality of a product (known in the industry as 'product scores') was only a minor factor. This suggests that some advisers are acting in their own interest, rather than in the best interests of consumers.

What we found:

- During the review period, policies sold through advisers were much more likely to be replaced after the 'clawback' period ended. This is the period when the adviser must repay a portion of the upfront commission they receive from the insurance provider if the customer cancels the policy.
- Policies with a high upfront commission and a lower trail commission were 1.6 times more likely to be replaced after the clawback period ended.
- Policies sold on a high upfront commission and a low trail commission were more likely to be replaced if the adviser was offered overseas trips as a sales incentive.
- Overseas trips appear to be an effective sales incentive for advisers. Policies no longer subject to clawbacks were 2.2 times more likely to be replaced if overseas trips were offered as an incentive. Even new policies still subject to clawbacks were 8% more likely to be replaced.

What are ‘product scores’?
Some financial advisers use research providers to help them review insurance policies and rate their features. These ratings are known as ‘product scores’. For this report, we used product scores for representative age categories from one research provider.

Policies per adviser

Our review shows that most advisers have only a small number of active policies on their books. However, some have a relatively high number of policies.

We are aware of some instances where policies matched to a single adviser may represent a business with more than one adviser, because of the way some businesses report their data. This may have some effect on our analysis, and we will explore this further when we follow up with advisers.

What we found:

In 2014, out of 3,700 advisers with at least one active policy:

- The median number of life policies for all advisers was 33.
- 31% of all advisers had no more than nine life policies.
- 25% of all advisers had at least 130 life policies.
- AFAs tended to have more life policies on their books than RFAs. The median number of policies for AFAs was 70. The median number of policies for RFAs was 26.

Range of providers

Our review shows that most advisers deal with relatively few providers.

What we found:

In 2014, out of 3,700 advisers with at least one active policy:

- More than half of advisers had at least 90% of their policies with only one provider.
- 23% of advisers had at least 90% of their policies with only two providers.
- 21% of advisers had at least 90% of their policies with three to six providers.
- The high-volume advisers were more likely to deal with multiple providers. Of these advisers, 36% had at least 90% of their policies with only one provider, 49% had at least 90% of their policies with two or three providers, and 14% had at least 90% of their policies with four or five providers.

Types of cover

The focus of this review is on life cover. However, we also analysed policies with trauma, income protection, and TPD cover. In 2014, there were 510,000 active policies that were sold through advisers. The vast majority of these (81%) included cover for life. The rest included various combinations of trauma, income protection and TPD.

At least one-third of the active policies sold by advisers were for life cover only[4].

What we found:

In 2014, out of 3,700 advisers with at least one active policy:

- At least one-third of all policies were for life cover only.
- 18% of all policies included cover for life and trauma.
- 7% of all policies included cover for life, trauma and income protection.
- 2% of all policies included cover for life, trauma, income protection, and total and permanent disability.

Adviser remuneration

The data we received from insurance providers did not enable all types of remuneration to be analysed. However, we were able to analyse upfront and trail commissions paid to most advisers. This showed that many advisers are unlikely to be relying on commissions from life insurance policies as their main income.

The data does not include bonus commission from all providers, so total remuneration paid to advisers is likely to be higher than these estimates suggest. Nevertheless, it indicates that only a small percentage of advisers are earning a very high income from life insurance commissions.

It should also be noted that some advisers earning high rates of commission may be acting in their clients' best interests. We are aware of many advisers who put considerable time and effort into assessing the suitability of various insurance policies for their clients.

What we found:

In 2014, out of 3,700 advisers with at least one active policy:

- Around 9% earned no commission from life insurance policies.
- Almost half (43%) earned less than the minimum wage in commissions from life insurance policies.
- At least 12% earned over $100,000 in commissions from life insurance policies.
- At least 4% earned over $200,000 in commissions from life insurance policies, and almost 2% earned over $300,000.
- One adviser earned over $320,000 from commission on 110 life policies (an average of $3,100 per policy). This adviser's lapse rate was 41%, and new business rate was 61%.
- Another adviser earned over $340,000 from commission on 270 policies (an average of $1,300 per policy). This adviser's lapse rate was 21%, and new business rate was 14%.

[4] Because of the differences in the way insurance providers record policies, the actual figure is between 32% and 45%.

‘High-replacement’ advisers

During the review period, there were around 1,100 advisers with more than 100 active policies. For our analysis, we have described this group as ‘high-volume’ advisers. Around 200 of these high-volume advisers also had a high estimated rate of replacement business. We have described these as ‘high-replacement’ advisers.

Many of these high-replacement advisers may be acting in their customers’ best interests. However, we took a closer look at this group because consumers are at a higher risk of having their policies churned by some of these advisers.

	High-volume advisers	High-replacement advisers
Average commission per policy On average, the high-replacement advisers earned nearly 50% more from commissions on life insurance than other high-volume advisers.	$410 per annum	$610 per annum
Overseas trips Insurance providers who sell through AFAs and RFAs offer overseas trips as sales incentives. Destinations during the review period included Shanghai, Prague, Las Vegas, Hollywood, Rome, New York and Rio de Janeiro. On average, the high-replacement advisers each took two of these overseas trips. One high-replacement adviser took 10 trips. The other high-volume advisers each averaged one trip.	33% 1 or more trips 13% 3 or more trips 5% 5 or more trips	57% 1 or more trips 30% 3 or more trips 13% 5 or more trips
Number of providers (with whom advisers have at least 90% of their life policies) The high-replacement advisers generally dealt with a wider range of insurance providers than other high-volume advisers.	64% 2 or more 37% 3 or more	81% 2 or more 51% 3 or more
Median policy age (as at June 2014) The high-replacement advisers had policies with a shorter median age than other high-volume advisers.	6 years	2 years

Why churn matters

There are two ways a consumer can be harmed by a financial adviser who churns clients:

- harm through the life of the policy
- harm at the time of claim.

Of wider concern is the possibility that New Zealanders are paying too much for life insurance, because insurance providers are spending too much on commissions to advisers due to churn. This may mean that some consumers who would benefit from life insurance are unable to afford it.

Harm through the life of the policy

When a consumer switches from an existing policy to a new policy, they may gain some benefits (such as a reduced premium), but they may also lose some benefits.

If the change is not in the best interests of a consumer, then this harms them. Examples of possible changes, and how these could harm a consumer, include:

- different policy exclusions (a consumer could have a medical condition that is excluded from the new policy)
- differences in cover (a consumer may have a medical history of heart disease, but the new policy has less coronary cover)
- a change in premium (a consumer may end up paying for insurance they don't need, or may pay lower premiums in the short term but higher premiums in the long term)
- a difference in the financial stability of the new insurer or reinsurer (a consumer may end up paying higher premiums, or find it harder to make claims)
- a difference in customer experience, service or claims processes (a consumer may find it harder to deal with their new insurer).

In this case, a consumer does not need to have a bad experience to be harmed. They are buying the transfer of risk, and the harm is the difference in risk transferred because of poor financial advice.

Why is the policy being changed?
We understand that it can be difficult to assess whether a replacement policy is better or worse for a consumer, due to the challenge of quantifying various policies' features, and fully understanding a consumer's circumstances. This is why it can be useful for consumers to get professional advice.

However, it is important that financial advisers themselves understand all changes made to a policy and explain these to the consumer, so the consumer understands the consequences of the change.

Harm at the time of claim

If a consumer claims on their policy and the claim is denied, they are harmed if their old policy would have paid the claim and they were unaware of the change in risk when the policy was replaced.

The harm to individual consumers in this case can be high. However, it is likely to affect fewer consumers overall than other types of harm.

How churn can harm consumers

This hypothetical scenario illustrates how churn can harm consumers:

Mary and Roger had health and life insurance with insurance company A. Their policies were more than five years old but they met with their financial adviser to discuss whether they could get the same level of cover with another company for a lower premium.

The adviser advised them to change their life cover to insurance company B and their health cover to insurance company C, which they did.

Two years later, Roger suffered a major heart attack and was unable to work for some time. He made a claim to insurance company B and insurance company C, but they both declined the claims because his medical records showed he had developed heart problems five years previously and it was therefore a pre-existing condition.

Harm to all consumers

Higher premiums — Unless policies are sold on level commission, financial advisers are paid higher commission on replacement business than they are paid on existing business. This higher commission is paid by providers, and is likely to be passed on to all consumers as higher premiums. If policies are being churned, all consumers are literally paying the price for this.

How churn affects adviser remuneration

This hypothetical scenario illustrates how churn can affect adviser remuneration:

John and Sam are financial advisers. They each acquired 50 new clients, who paid an average premium of $1500 a year for their life insurance.

John and Sam both received an upfront commission of 180% of their clients' premiums in the first year, plus 8% in trail commission.

After two years, they both reviewed their clients' policies. John kept all 50 of his clients on the same policies. Sam kept 30 of his clients on the same policies, but the other 20 replaced their policies.

Even though they had the same number of clients paying the same annual premiums, Sam earned almost 10 times as much as John that year.

	Total clients for John and Sam	Total paid in annual premiums	Commission earned by John	Commission earned by Sam
Year one	100	$150,000	$135,000	$135,000
Year two	100	$150,000	$6,000	$6,000
Year three	100	$150,000	$6,000	$57,600
Total over three years	**100**	**$450,000**	**$147,000**	**$198,600**

Underinsurance — When advisers spend time recommending existing customers replace their policies, they cannot spend that time selling to customers who have no insurance. This could mean that some consumers who would benefit from life insurance are missing out.

Poor financial advice — Dispute resolution schemes such as Financial Services Complaints Limited deal with various complaints about life insurance. Some of these cases are discussed in their annual reports. Some consumers also contact the FMA with their concerns. However, it is likely that some issues are not reported, so it is difficult to gauge the extent of poor advice.

How we compiled this report

How we collected this information

In May 2015 we requested four years of data from the 12 main insurance providers in New Zealand, under section 25 of the FMA Act. The data covers the period from 1 April 2011 to 31 March 2015. We acknowledge the support and resource applied by insurance providers to collate and supply this information.

We matched 3,700 advisers across the 12 providers using their Financial Service Provider registration number (FSP number) during the period July 2011 to June 2014. Around 1,100 of these advisers had more than 100 life insurance policies on their books, 360 of which were AFAs.

Replacement business

We analysed the policy lapse rates and new business rates by adviser during the period. We analysed the minimum of these metrics by adviser – the lower of lapsed policies and new policies is the potential number of replaced policies from among the adviser's own clients. Our overall estimate for replacement business may include genuine new business and genuine lapses. This will not include cases where an adviser recommends replacing a policy to a person who is not already their client.

Policy survival

We ran 16 models to determine the effects of commission structure, overseas trip offers, and other benefits on policy cancellation.

Definitions

Providers refer to different types of cover in a policy (such as life, trauma, income protection and TPD) as 'benefits' or 'riders'. A policy may cover more than one person. Many providers were unable to separate their premium and commission data by 'benefit' and only had data at the overall 'policy' level. Many providers also regard buying greater levels of cover as new policies.

For premium data, we requested that the 'premium paid' be provided. Providers summarised customer payments to provide this data.

Scope and design

We limited our scope to exclude credit insurance. Mortgage insurance (a form of credit insurance) is sometimes sold as a substitute for income protection insurance. Therefore we cannot identify instances where advisers replaced income protection insurance with mortgage insurance or vice versa. Our review also excluded group policies, and policies that had an investment component.

We did not try to track policyholders or lives insured across providers, due to the inaccuracy of text matching. Instead, we examined volumes of policies by adviser.

For our analysis of commissions, we used a Cox proportional hazard model of survival with time-dependent covariates. We then ran analysis of variance on the hazard ratios.

Data provided

Not all providers were able to supply all the information requested. When our analysis relied on FSP numbers, we excluded a small number of records with invalid FSP numbers.

Some advisers and insurance providers have processes that match policies to the adviser who signed the agency agreement, rather than to the adviser who sold the policy or to the adviser business. This means that some policies we matched to one adviser may represent an adviser business with multiple financial advisers.

Glossary

Active policy	A policy is active in a given period where the benefit start date is before the end of the period and it did not cancel within 90 days of the benefit start date and it did not cancel before the beginning of the period.
AFA	Authorised Financial Adviser – an individual financial adviser authorised by the FMA to provide certain services.
Churn	A consumer is moved to a new policy based on the commission and incentives payable to an adviser, rather than because it is in the customer's best interest.
Clawback period	The period within which a financial adviser must repay a portion of the commission they received from an insurance provider if the policy is cancelled.
Dealer group	A group funded by commissions on members' product sales. By aggregating sales, members may earn higher volume-based commission bonuses.
FADC	Financial Advisers Disciplinary Committee
FMA	Financial Markets Authority
FMA Act	Financial Markets Authority Act 2011
FMC Act	Financial Markets Conduct Act 2013
High-replacement advisers	AFAs and RFAs with more than 100 active life policies on their books, who also have a high estimated rate of replacement business.
High-volume advisers	AFAs and RFAs with more than 100 active life insurance policies on their books.
Lapse rate	The number of policies not renewed compared to the same number of policies that were active at the beginning of the same period.
Product score	A rating system developed by research providers to help financial advisers review insurance policies and rate their features.
QFE	Qualifying Financial Entity — a business that takes responsibility for the financial advice followed by its employees and contractors, without those people having to register as advisers individually.
Replacement business	A consumer moves their policy from one insurance provider to another.
RFA	Registered Financial Advisers — an individual adviser who is registered on the Financial Service Providers Register but who is not authorised by the FMA.
TPD	Total and permanent disability — this is a type of life insurance cover.