The Insurance Institute of Manchester

# The New Class 2015-2016 Report 1: The Insurance Act 2015

## The Effect on Insurers and Policyholders


# Contents

## Meet The New Class

During the summer of 2015, the Insurance Institute of Manchester was inundated with applications from candidates eager to achieve a place on 'The New Class 2015' programme, lead by Stephen Bridge ACII from the council. Sixteen successful candidates were selected to participate in a tailored training programme, sponsored by LV=, to help them develop both themselves and the industry.

Under the guidance of institute vice presidents, Fintan Griffin ACII and Karen Cartridge Dip CII, the teams engaged in soft skills sessions including public speaking, report writing and project management. The group, split into two teams, had to then utilise these skills to create a report based on the implementation of the Insurance Act 2015, for release August 2016.

The following report has been created by 'Team Karen' focusing on the effect on insurers and policyholders. We hope that you find our work to be a compelling and interesting read.

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## Target Audience

Our report is directed at all insurers within the insurance industry in order to provide an insight into the changes the Insurance Act 2015 (here after referred to as the Act) will bring about. The document will take you on a journey from the situation prior to the Act through to the predicted consequences of its implementation, all through the perspective of an insurer. We will conclude with a critical analysis of the Act.

Nevertheless, if you are not an insurer or if you do not work within the insurance sector, we believe you will still find our report a compelling read. The subject matter discussed is thoroughly interesting and our report provides an overview of a historic legislative change.

*"The changes (in the Act) bring improved transparency and fairness to our policyholders"*

**Neil Clutterbuck, Director, Underwriting and Technical, Allianz Insurance**

*"The Act should give the end customer more confidence and fewer surprises"*

**David Williams, Managing Director, Underwriting, AXA Insurance**

*"The Act clarifies the responsibility of clients and insurers in the process of making a fair presentation of a risk, and in so doing should provide great certainty of outcome for our clients."*

**Mike Shelley, Manchester Head of Office, Marsh Limited**

## Snapshot

As of the 12$^{th}$ August 2016, the Insurance Act 2015 will come into effect for England, Wales, Scotland and Northern Ireland. The Act is widely recognised as the most significant change to insurance related legislation in the last 100 years. The Marine Insurance Act 1906 will be referred to in detail (here after referred to as the MIA).

The introduction of this new legislation has in some form or another been ongoing for 25 years and is attempting to introduce a new and fairer balance between the non-consumer policyholder and insurer, in the way the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA 2012) has for consumer polices. This Act applies to all non-consumer and re-insurance policies and affects a number of responsibilities between the policyholder and insurer. The changes themselves are not groundbreaking in their originality but seek to prompt fair and reasonable practices from insurers and brokers.

# Insurance Act 2015 - Before (pre August 2016)

## Utmost Good Faith

Utmost good faith is the positive duty on both parties of the insurance contract to disclose all material facts accurately and fully in relation to the risk being presented (Carter v Boehm 1766). This applies to both consumer and non-consumer insurances. The potential policyholder is expected to know and disclose all material facts relating to the risk they wish to insure. Material facts are those that would influence the judgment of a prudent underwriter as to whether they should or should not accept the risk, what terms they wish to apply and what premium they require.

Should one party breach utmost good faith, the breached party can avoid the contract. In the context of insurance policies for example, should the insured breach utmost good faith by say non-disclosure of non-spent criminal convictions, under Section 17 of the MIA, insurers would have the right to void the policy and the premiums would be returned to the insured. Insurers may waive their right to do so or be estopped from doing so by their actions i.e. paying out for part of a claim thus giving the insured the impression the claim is covered and the policy is still valid. Insurers only have to prove that a reasonably prudent underwriter would have wanted to know of the facts, even if the prudent underwriter would not have acted differently in terms of accepting the risk or applying different premiums.

This stance on utmost good faith may be seen as unfair towards policyholders. They are expected to know and disclose any information a ‘prudent underwriter’ would want to know, however very little advice is given to explain what this means.

## Warranties

An insurance policy is fundamentally a written contract between the insured and insurers. The insured agrees to comply with the terms of the contract and the insurers agree to pay any valid claims that arise under the insured events. There are different types of terms within contracts: warranties being one; suspensory conditions being another. The main difference between these terms is the remedy available to the damaged party if a term is breached. A warranty in an insurance contract is an unconditional promise by the insured that certain facts are true at the date of the inception of insurance, or will remain true throughout the period of insurance, for example a 'basis of contract' clause.

In terms of contract law, a breach of a warranty will automatically end the liability of the insurers, as they are the injured party. This means the policy is void, even if the breach is remedied. Therefore no claims should be paid out and any premium paid would be returned to the insured, it is irrelevant whether the breach is material in any way to the loss. For example, if a policy was subject to a security warranty where locks and a working intruder alarm are required. In the event that the insured did not have a working alarm, insurers would be entitled to repudiate a claim for damage by flood. This is unfair towards the insured and one of the imbalances the Act is designed to prevent.

**Fraud**

Submission of a fraudulent claim would mean that the insurers can void the policy from the date the fraud was committed and therefore not pay the current or any future claims arising out of this policy. Any money already paid out in relation to the current claim should be returned to insurers or they can take action to reclaim it from the recipient (Axa v Gottlieb 2005). However, any genuine claims that were committed before the fraudulent act would still be valid. Insurers do not have to return the premium to the insured if the policy is void due to the existence of fraud.

## The Insurance Act 2015 - Now (August 2016)

**Utmost Good Faith and the Duty of Fair Presentation**

Utmost good faith is abolished and replaced with a duty of fair presentation. The Act states *'any rule of law permitting a party to a contract of insurance to avoid the contract on the ground that the utmost good faith has not been observed by the other party is abolished*'(Part 5). This removes insurers ability to avoid a policy from inception for breach of utmost good faith. Now insurers and the insured must comply with a duty fair presentation. The responsibility is with insurers to request the information they need to assess the risk in order to make an informed underwriting decision, calculate a suitable premium and/or apply any specific endorsements to the quote.

Although the responsibility is with the insurers to obtain the required information from a potential insured, the insured is still required to present the risk fairly and thoroughly, they must disclose all material facts when answering insurers questions. What is considered a material fact has not been changed and just as prior to the Act, the insured does not have to disclose something that would diminish the risk, or anything that the insurers are presumed or ought to know, such as if a building is in a low laying flood prone area. The insured should still take care to present the risk accurately.

Insurers still have options in the event of a breach, which option depends on the size of a breach and the insurer's discretion. Under the Act insurers have four options depending on the circumstances of the breach:

1. A deliberate or reckless breach can be handled by the insurer opting to avoid the policy and keep any premiums paid.
2. If a breach is not deliberate or reckless, but the insurer wouldn't have provided cover if certain information had been presented before inception, they are able to avoid the policy but must provide a refund of premiums paid.
3. If a breach is not deliberate or reckless, and the insurer would have provided cover albeit with different terms, then the insurer will be able to treat the policy as if those different terms applied. This can only be applied if the insurers would have offered different terms when offering cover.
4. If the insured breaches the duty in a way that is not deliberate or reckless, but the insurer would have incepted at a higher premium, then the policy is still in force.

Insurers can use 'average' to reduce the claim payment proportionate to the actual premium the insured paid.

Insurers must also prove a breach happened, and that their decision to insure the risk would have been affected if the breach had not occurred. For example, insurers may be required to provide examples of similar cases where the same terms were applied or provide copies of underwriters acceptable risk profiles.

This is a subtle but significant change to the principles of insurance. Whereas previously the insured was expected know the mind of an underwriter and disclose all relevant information, now they simply have to take reasonable care to answer insurers' questions honestly and correctly, therefore fairly presenting themselves and the risk they wish to insure.

**Warranties**

The Act turns the use of warranties on its head for insurers. Section 11 of the Act outlines these changes. Now it is for the insured to provide evidence at claim stage that the breach of warranty or policy condition did not cause or exacerbate the incident. If this can be proven the insurer will be liable for the claim. There is ambiguity as to the extent the insured may have to go to satisfy the insurer, which is made harder without any case precedent to refer to. If a business breaches a warranty, the insurer's liability is suspended for the duration of the breach. If the breach is remedied before a loss occurs, the insurer has to pay the claim. Basis of contract clauses are abolished for all classes of insurance

To give a competitive edge some insurers have started providing 'warranty free' policies. This mirrors the Act and acknowledges that it is unfair to penalise an insured due to a technicality which had no bearing on the claim.

On the occasions where the breach of a warranty has caused or affected the loss, then the insurer can no longer void the policy and decline to accept liability. The insurer will be able to amend terms and premium at claim stage, to those a prudent underwriter would have offered at quote stage. Again the insurer has to evidence that this would have been the case.

The Act now defines a prudent underwriter in line with what the company approach would have been, taking into account their underwriting training guides and risk appetite, rather than just a sole underwriter's view. If the premium would have been greater than the currently charged premium, then the percentage of the claim cost is taken into account against the new premium with a proportionate amount paid out.

**Fraud**

The Association of British Insurers (ABI) researched fraud and established that insurers reveal £3.6 million worth of fraud every day. There is no denying fraud is a big problem within the insurance industry. With fraud being such a significant issue it is not surprising to find that insurers' remedies have not been relaxed by the Act. The Act has simply looked to confirm and clarify insurers' options.

This applies to both consumer and non-consumer policies. Section 12 that the Act confirms that insurers are not liable to pay any fraudulent claim and may recover any payments made to the insured in respect of that claim. Additionally, they may also treat the contract as having been terminated from the date of the fraudulent act and retain any premiums paid by the insured. The Act confirms they will not be liable for any claims occurring after the fraudulent act, genuine or not. They will however still be liable for genuine claims occurring before the fraud. The interesting point to note is that the Act allows insurers the option, it does not occur automatically. This allows insurers more commercial flexibility.

The second interesting point is that the Act distinguishes between a ‘fraudulent act’ and a ‘fraudulent claim’. It does not provide a definition for these terms or ‘fraud’ or ‘fraudulent’ so we should continue to use common law principles when considering what is fraud. A statement or action must be substantial, wilful and materially false to be considered fraudulent. Our reading has lead us to believe a ‘fraudulent claim’ is, for example, a staged event and the entire event is fictional and fraudulent. A ‘fraudulent act’ could be the addition of a fraudulent element to an initially fortuitous and genuine claim such as altering an invoice. The significance of this is that the date of the fraud is the date the fraudulent element is added to the genuine claim not the date the claim was submitted.

The Act (Section 13) also clarifies the position where a fraudulent claim is made by one beneficiary under a group insurance contract. Insurers have the same option as noted under Section 12 but only in relation to the fraudulent beneficiary. This means cover provided for the other ‘innocent’ beneficiaries remains in force and unaffected. The aim is to ensure that innocent members of the group are not unfairly prejudiced by the fraudulent actions of an unrepresentative few. For non-consumer policies, insurers can contract out of this provision as long as they have complied with the transparency requirements noted within the Act.

**Contracting Out**

Section 16 of the Act allows the insurer and insured to contract out of the provisions of the Act, apart from the basis of contract clauses.

If an insurer does decide to offer what is considered an unfavourable contract term they must follow the transparency requirements from Section 17 of the Act ‘*The insurer must take sufficient steps to draw the disadvantageous term to the insured’s attention before the contract is entered into or the variation agreed*.’ and ‘*the disadvantageous term must be clear and unambiguous as to its effect.*’

## The Enterprise Act 2016

On the 4th May 2016 Royal Assent was granted to the Enterprise Bill with the aim to protect and support SMEs. The Enterprise Act seeks to follow on from the changes brought about by the Insurance Act 2015 with the provisions relating to insurance claim payments coming into effect on the 4th May 2017.
One of the key provisions of the Act is covered in Part 5 and relates to the late payment of insurance claims. As summarised by **Kennedys Law (2016),** the new piece of legislation requires insurers to:

- Pay claims within a 'reasonable time'
- Provide a non-exhaustive list of matters which may be taken into account when determining what is a 'reasonable time' for payment
- Contract out of the default rules for non-consumer insurance contracts, providing they have satisfied the transparency requirements set out in the Insurance Act 2015

One of the key aims of the Enterprise Act was to provide all policyholders with a legal right to ensure they receive any insurance claim payments promptly following the claim notification; should the insurer fail to comply, limited compensation will be available if the insured suffers any additional loss due to the insurer’s payment delay.

This was a controversial change to the industry and it is likely those who work within a claim handling functions will experience the repercussions for several years to come. Originally this was to be included within the Insurance Act 2015 but it was such a contentious point, it was dropped to allow the Act to progress. It is now included in the Enterprise Act.

# The Insurance Act 2015 - After (post August 2016)

### Duty of Fair Presentation

The introduction of the Act balances the responsibilities between the insured and insurers. Utmost good faith was very much a duty that required the insured to present their risk fully without much input from insurers. Now there is balance and insurers must ask the correct questions and the (potential) insured must answer them correctly. The balance is shifted from the insurers to the insured, and insurers must ensure they complete thorough investigations into the risk prior to offering cover, including asking the correct questions of the insured.

Additionally brokers must ensure they are supplying a fair presentation of the risk to the insurer, ensuring they pass on everything the insured disclosed to them. This does not diminish the insured's responsibility to satisfy the duty of fair presentation. It will help ensure they are giving the insurers sufficient information to allow them to identify if they need to make more enquiries. Going forward this should hopefully create a fairer system and if more investigation is required then brokers will be required to carry out more intensive validation checks.

### Warranties

The changes that will happen once the Act comes into effect will mean that insurers don't hold the same protection as they had with the MIA, previously they abided by the avoidance only system. The remedies provide more balance and should hopefully result in less policy avoidance as the insurers will not be able to void claims as easily, making it fairer on the insured.

The remedies will depend upon what the insurer would have done had the risk been presented correctly at the time of inception, either by varying the terms of the policy, increasing the premium, or avoiding the policy. The introduction of these remedies will help restore the balance between the insurer and the insured and ensure insurers' actions are proportionate to the impact of the breach.

### Fraud

The Act has confirmed what happens in the event of a fraudulent claim but has not made any significant changes with regards to how a fraudulent act is handled by the insurer. Hopefully with the changes made to the duty of disclosure, insurers will be encouraged to complete a higher level of investigations when necessary which is a step towards minimising fraud in the insurance industry.

## Impact of the Act

The Act looks to provide a lot of positive changes to the insurance industry. While we cannot be certain, it is realistic to hope the following will be achieved.

- **Improvement on the exchange of information between insurers, brokers and customers**
  As noted in the 'Before' section of this report, the insured had to disclose all material facts to an underwriter. The Act clarifies and balances the position through the duty of fair presentation. This clarity should provide the insured with more insight and confidence to know what needs to be disclosed.

- **Reduced number of disputes**
  The Act has abolished the use of 'basis of contract' clauses which have the effect of converting a declaration of truth into a warranty. If the answer turns out to be false, the insurer is discharged from liability irrespective of materiality. Now there will have to be full transparency from the insurer where they would like to contract out. Policy terms and wordings need to be unambiguous to avoid leading to increased litigation.

- **Reducing the amount of claims unfairly rejected by insurers**
  Previously many insureds had claims declined for what was perceived as arbitrary reasons. The new position is more realistic. A breach of warranty will not automatically discharge the insurer's liability under the contract but rather suspend the insurer's liability under the policy until such times as the warranty is complied with. This is a much more equitable outcome to what went before and will reduce the amount of rejected claims.

- **More training for staff**
  Insurers will need to ensure they have greater standardisation of their underwriting procedures and ensure that the information is shared amongst all their underwriting departments. They may also want to engage more with brokers and third parties to deliver training on what they expect from them. This will help them have a greater understanding over what is required from them to make sure they are making a fair presentation of the risk to the insurer. Moreover staff within the underwriting and claims departments of insurers will need to receive training and understand the impact the Act has on their role and any implications.

- **Improve the image of the UK insurance industry**
  The Act is not a dramatic change, it is what should be happening in the insurance industry. The Act will bring the law up to date and in line with modern day practice. It will bring greater clarity, transparency and balance in the market place, hopefully making things fairer for the commercial customer. There is no doubt this legislation will contribute to improving the image of the industry as it sets out to rebalance the law in favour of the insured as the previous MIA was weighted in favour of the insurer to protect the fledgling industry at the time.

## Industry Review – Analysis of the Act

"*The UK is one of the world's leading insurance jurisdictions, and outdated and unused provisions undermine the respect with which the law of the UK is held"*
**(Commission, Office, and Great Britain: Scottish Law Commission, 2011)**

The insurance market has changed dramatically since the 18th and 19th centuries, when the MIA provided the foundation for insurance legislation. 110 years on and the insurance market has undergone a whirlwind of change but the area of legislation has always lagged 5 steps behind: "*The law has failed to keep pace with these changes. It fails to reflect the diversity of the modern insurance market…nor does it reflect developments in other areas of commercial contract law"* **(Commission, Office, and Great Britain: Scottish Law Commission, 2014).**

It is without question that reform was needed to provide an accurate reflection of the current market position and the present day industry practice. However, is the implementation of the Act sufficient enough to create a fair balance between insurer and policyholder or should the market expect to see further legislation to bring the UK insurance industry into the 21st century?

Insurance brokers, Marsh & McLennan argue that the Act is a positive step forward for the insurance market. They believe that: "*The Act redresses an imbalance in the existing law, which is sometimes overly in favour of insurers"* **(Marsh Limited, 2015).**

The new Act now removes the ability for an insurer to discharge all liability following a breach of a warranty, regardless of whether the breach was related to the subsequent loss or not. Under section 10 of the Act all warranties will now become 'suspensive conditions' which means that an insurer will be liable for any losses that occur once the breach has been remedied. This change is reflective of the current market regulatory position of Treating Customers Fairly (TCF) and provides an equitable rebalance between the insured and the insurer. On the surface this appears to be a key strength of the Act, however in reality it merely appears to be an echo of a system already in force.

As in the case of Kler Knitwear v Lombard General Insurance Co Limited [2000] the courts took the stance of "*disregarding clear language and called a warranty a suspensive condition in order to avoid a draconian result"* **(Judith Summer, 2010).** Nonetheless, the Law Commission believed that this judicial approach introduced an element of "*uncertainty and confusion"* **(Commission, Office, and Great Britain: Scottish Law Commission, 2006)** and opted to adopt all legal doctrines, precedents and changes within the law into the new Act. This element of codification seeks to provide clarity surrounding all the controversies around warranties.

The new Act has also received an optimistic response from insurers including Allianz Commercial who have stated "*these changes bring improved transparency and fairness to our policyholders"* **(Neil Clutterbuck, 2015).** Under the MIA, policyholders were required to disclose and predict every circumstance that would influence the decision of a prudent insurer. This seemingly impossible and unfair task will now be overhauled by the Act which is "*aimed at encouraging active, rather than passive, engagement by insurers as well as clarifying and specifying known or presumed to be known matters"* **(LLP, 2016).**

The duty of a fair presentation will shift the onus onto brokers to provide clear and detailed presentations, opposed to the current practice of 'data dumping'. Regardless of all these advantages of the Act, they constantly appear to be overshadowed by the omitted provisions by the Law Commission such as the much needed reform of the various anomalies regarding insurable interest. The Law Commission failed to include areas such as the proposed abolition of s22 MIA and s53(1) MIA which makes the broker liable for payment of premium of marine policies. These exclusions undoubtedly weaken the Act but "*whether there will be further political appetite to implement these changes in the near future remains to be seen"* **(Jon Turnbull & Michelle Radom, 2015).** On the balance of probabilities, it appears as though "*the Act goes some way to redress the imbalance under the current law between the interests of the insured and the insurers"* **(Willis Limited, 2015)** but only time will tell if the Act goes far enough or whether further reform will be needed.

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