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1st Runner-Up Paper

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Offset Clauses

The offset clause has long been an important feature of income protection insurance. It has the practical effect of allowing an adjustment to benefits paid under a policy, on account of other monies which may be received due to the claimed condition. This is crucial in ensuring benefits paid are in line with a customer's pre-disability income.

The offset clause is one of the most disputed elements of income protection and the courts have adopted a policy of strictly interpreting the words of the clause in the narrowest possible sense.

Explain the purpose and objective of the offset clause and why it is important to the sustainability of income protection insurance. Explore the challenges the industry faces in its ability to offset. Address what steps can be taken by life insurers to ensure that an offset clause is likely to operate in the manner intended.

Please feel free in your answer to reference the impending changes to income protection cover as a result of APRA's recent sustainability directives on this product.

Income protection offset clauses: the what, why and how

The essential purpose of an insurance policy is to protect against financial loss. Ideally, restoring the insured person to the position they would have been in had their loss not occurred. Inherent to this is the principle of indemnity. This holds that an insurance policy should not compensate an insured for an amount which exceeds their actual loss. In recent times income protection insurance has been observed to violate this principle, offering overly generous product features that have resulted in windfall gains to insureds.¹ This has led to significant adverse financial experience for life insurers, continued premium increases and affordability challenges for policyowners.

In September 2020, the Australian Prudential Regulatory Authority (APRA) issued a directive, which outlined sustainability measures that life insurers were expected to make to their individual income protection products.² At the heart of APRA's recommendations was the principle of indemnity, with insurers being instructed to ensure product benefits do not exceed an insured's earnings at the time of claim.³ The indemnity principle is also enshrined in group insurance, where benefits must be consistent with prescribed statutory conditions of release. For income protection, this mandates that benefits only be provided for the purpose of continuing the gain or reward (i.e. income) which the insured member was receiving before their disability occurred.⁴

This paper looks at one of the product features that supports the indemnity principle - the offset clause. It examines the role these clauses play in ensuing products are sustainable, while still meeting the needs of policyowners. Consideration is also given to the way in which offset clauses have been approached by judicial bodies and the types of things insurers should be aware of when drafting.

What... does an offset clause do?

An offset clause aims to ensure that the totality of money received by an insured person while on claim, does not exceed their pre-disability income. It does this by permitting the insurer to reduce the benefit payable, on account of other amounts the insured has received (or is entitled to receive) for the same period. The other amounts by which the benefit is reduced or 'offset' are generally those which have some connection to the injury, illness or income earning capacity of the insured. These include things such as:

- benefits received under other life policies,
- payments received under statutory compensation schemes (such as Workers Compensation)
- social security payments, and
- amounts paid from the insured's employer (including sick leave or annual leave).

¹ Letter from the Australian Prudential Regulatory Authority dated 30 September 2020 to all Life Insurers and Friendly Societies: FINAL INDIVIDUAL DISABILITY INCOME INSURANCE SUSTAINABILITY MEASURES ([link](#)). It is acknowledged that the principle of indemnity is generally regarded as being of limited relevance to life insurance contracts which are written on a contingency, rather than indemnity basis. However, the relevance has arguably increased in recent times as the distinction between life insurance and indemnity insurance has become increasingly blurred: see for instance the observations by the UK Law Commission in Consultation Paper No 201: INSURANCE CONTRACT LAW: POST CONTRACT DUTIES AND OTHER ISSUES ([link](#)). Modern income protection products in particular, bear a number of hallmarks of indemnity insurance and are often provided for the purpose of providing an indemnity for the insured's lost income.

² APRA (30 September 2020)

³ In an earlier industry wide letter in December 2019, APRA specifically noted that it was introducing the sustainability measures to drive changes in product features that violate the principle of indemnity.

⁴ See *Superannuation Industry (Supervision) Regulations 1993*, Schedule 1, Item 109

Amounts received by the insured which are more passive in nature, such as investment earnings, will generally not be offset.

Why...should a policy contain an offset clause?

Offset clauses support the principle of indemnity by placing an adaptable cap on benefits. This ensures that an insured is properly, but not overly, compensated throughout the duration of a claim.⁵ There are a number of reasons why this is important.

It aligns with the basic purpose of insurance... An insurance contract should only indemnify an insured for their loss. It should not enable them to improve their position. The potential for profit moves the arrangement beyond one which protects a pre-existing interest and instead creates something more akin to a wager. As the High Court of Australia has observed “the law does not allow gambling in the form of insurance”.⁶

It helps to prevent fraud... There is a perverse incentive to make a claim, if doing so results in the insured being placed in a better financial position. While in practice the risk of outright fraud in income protection is not thought to be significantly high,⁷ there remains a risk that an insured could exaggerate the extent or impact of their condition in order for a benefit to accrue. This is of particular concern for conditions that are highly subjective in nature and for which medical practitioners rely on the insured’s self-reported symptoms to assess disablement.

It improves health outcomes... Work is a powerful determinant of health. Studies consistently show that returning to work after illness or injury can deliver many benefits to the insured, their employer and society as a whole.⁸ However, benefits that effectively reward the insured for staying on claim create a non-medical barrier that prevents this from occurring. An extended claim duration is adverse in itself. It can cause an insured to adopt a disabled mindset and lose confidence in their work capacity. A number of studies reflect this, showing that the longer a person remains on claim, the less likely a return to work in the future becomes.⁹ It is therefore in the insured’s best interest to remain incentivised to return to work at the earliest possible opportunity.

It improves product sustainability... If an insured can earn more on claim than they did while working there is no incentive, at least financially, for them to try to phase off benefits. This leads to increased claim lengths, which leads to higher claims costs for insurers, which eventually leads to increased premiums for insureds. Excessive and/or longer-term benefits also distort the spreading of risk. As the product becomes increasingly costly healthier policyholders either pay more to cover the cost of those who are on claim or exhibit a greater tendency to cease their insurance cover.¹⁰ It is therefore of imperative importance to the ongoing sustainability and availability of income protection insurance in Australia that the principle of indemnity in benefits is maintained.¹¹

⁵ Turks Legal (undated) Top Tips: Offset Clauses ([link](#))

⁶ *British Traders Insurance Co Ltd v Monson* (1964) 111 CLR 86, per Kitto, Taylor and Owen JJ.

⁷ There are a number of methods adopted by insurers to alleviate the risk of fraud. In fact, insurers are required under the APRA Prudential Standards to have an appropriate risk management programmes in place to manage risks to financial security, including insurance risk and fraud.

⁸ NSW State Insurance Regulatory Authority (October 2020) Reversing the trend: Improving return to work outcomes in NSW ([link](#))

⁹ Royal Australasian College of Physicians (October 2011) Position Statement: Realising the health benefits of work ([link](#))

¹⁰ Actuaries Institute (May 2021) Individual Disability Income in Australia ([link](#))

¹¹ APRA letter (September 2020)

How...should an offset clause be constructed?

Given the valuable function an offset clause performs, it is not surprising that they are a common policy feature in most jurisdictions.¹² That said, it has been noted that the approach taken by insurers can and does vary significantly.¹³ While it is acknowledged that there are many acceptable ways to construct an offset clause, there are perhaps two key principles that insurers should keep in mind.

The clause needs to be clear and precise... An insurance policy is a species of commercial contract. As such, the words of the policy should generally be construed so as to give effect to the commercial purpose the policy is intended to secure.¹⁴ However, when it comes to offset clauses, judicial bodies have been noted to take a far more literal approach.¹⁵ This more exacting lens means that insurers will encounter problems if the wording used does not precisely match with their intent. Careful thought is therefore required as to both the types of payments the offset clause is aiming to capture and whether the wording adopted appropriately supports this intent.

For instance, an offset clause may be framed to reduce the benefit payable on account of other income amounts the insured receives while on claim. It is important to note that the word 'income' will not be read as applying to any other 'benefit' or 'monetary amount' the insured may receive, but only those amounts which are income according to ordinary concepts.¹⁶ In practice, this will capture a lot of the payments an insurer may wish to offset. As an amount will be generally be deemed to be income (according to ordinary concepts) when it shows the tell-tale signs of periodicity, recurrence, and regularity.¹⁷ This includes amounts paid under other income protection policies or regular benefits paid under statutory compensation schemes. Also, as lump sum compensation payments assume the same character as the thing they replace, it would also cover awards for loss of an income nature, such as lost wages. However, it does not include an amount received for the loss of future earning capacity, which is considered to be capital in nature.¹⁸ Importantly this includes awards made in accordance with the Workers Compensation and/or Motor Vehicle Injuries legislation. The same is true of a sum paid by way of compromise of a claim for damages (i.e. under a settlement agreement). If insurers wish to capture such amounts, they will need to ensure their offset clause is drafted accordingly. A degree of care also needs to be taken with other commonly used terms such as 'paid', 'payable', 'earned' or 'received'. While these terms may be thought of as somewhat interchangeable, they all have slightly different

¹² In a recent review of income protection insurance, the Actuaries Institute observed that offset rules similar to those found in Australian policies were present in products offered in the US, UK and South Africa. See Actuaries Institute (January 2019) Disability Income: An International Comparison 2019 ([link](#))

¹³ Turks Legal (December 2020) Offset clauses – The essential elements ([link](#))

¹⁴ *White v The National Mutual Life Association of Australasia Limited* [2003] NSWSC 1209

¹⁵ Turks Legal (December 2020)

¹⁶ This is subject of course to any specific meaning that may otherwise be given to the term 'income' in the policy itself.

¹⁷ *Federal Commissioner of Taxation v Dixon* (1952) 86 CLR 540. I

¹⁸ See for instance *Susan Buswell v TAL Life Limited* [2018] NSWSC 1507. In this case Mrs Buswell was in receipt of a benefit under a group salary continuance policy. She also commenced a common law damages claim against her employer and received a damages lump sum award. The Court held that the damages award could not be offset pursuant to an offset clause that applied to amounts of "income...which an Insured Person may derive during a month for which the Benefit is payable...including any benefit under any workers compensation...or similar schemes...". The Court noted that the insurer should be "well aware of long-established principles that determined that an award of damages for personal injury was considered compensation for a loss of a capital asset and not as income".

meanings.¹⁹ Insurers should be careful to ensure that their selected terminology aligns with the intended effect.

It is also not uncommon for an offset clause to list out some specific amounts that the insurer intends to capture and end with a catch-all provision that refers to “other similar amounts”. This is used with the intention to capture other possible payments that have some general characteristic or qualities in common. Insurers should be aware that in practice the degree of similarity required is fairly high. In some instances arguably verging on the identical.²⁰ Reliance on catch-all wording should therefore be used with some degree of caution.

The clause needs to strike a fair balance... The fairness revolution in financial services continues to gather pace. AFCA has declared that its mandate permits it to “*move decisions away from strictly relying on the applicable legislation or the terms and conditions of the disputed financial product to a decision which also contemplates fairness*”²¹ and has demonstrated the elasticity of this approach in a number of cases.²² The laws governing unfair contract terms also now extend to consumer insurance contracts, meaning that if an offset clause is deemed to be unfair, it may be void and of no effect.²³ Some thought must therefore be given to ensuring an offset clause remains reasonably balanced.

Whether or not an offset clause is fair depends upon a number of factors.²⁴ This includes the transparency of the clause, which will be influenced by how clearly it is written and whether it is in language that is easy for the insured to understand.²⁵ Consideration will also be given as to whether sufficient prominence has been given to the clause, relative to its impact on an insured. For instance, whether disclosure documents appropriately explain how the clause will operate and the effect it will have on the benefit received. It is important that insurers monitor their policies and disclosure documents to ensure offset clauses are adequately explained. That said, transparency will be of limited value if the operation of the clause

¹⁹ For instance, the term ‘received’ will generally have a wide application, applying simply where an amount finds its way into the insured’s hands. See *Maund v Crown in right of the State of New South Wales* [2013] NSWCA 226. However, it would not apply to amounts the insured may be entitled to but has not yet collected. The terms ‘earned’ or ‘payable’ would apply to amounts the insured has accrued an entitlement to. However, these terms may be limited to amounts for which the entitlement arises by way of some connection to the personal exertion (or inability to perform personal exertion) of the insured. For instance, in *FOS Determination 287412*, FOS held that an offset clause which included “amounts payable from the Insured Person’s employer or business” only applied to amounts payable in connection with the insured’s personal exertion (or inability to perform that personal exertion). It therefore did not entitle the insurer to offset amounts of business profit the insured was receiving in their capacity as director and shareholder of the business (despite these amounts having been included in determining their pre-disability income).

²⁰ See for instance *FOS Determination 286981*, where the insured held both an income protection policy and a loan protection policy (in connection with a personal finance arrangement). The insurer sought to offset benefits received under the loan protection policy on the basis of their policy’s clause which offset “any payments made under any other policies of a similar nature.” FOS determined that while both policies applied in connection with a disablement for work (from the same condition) and provided periodic income support for the insured, they were not of a similar nature. The payments under the loan protection policy were made to the insured to cover their obligations under a credit contract and not to replace the insured’s lost income more generally.

²¹ See AFCA (April 2021) Operational Guidelines to the Rules

²² See for instance *Turks Legal* (July 2020) AFCA disregards policy trauma definition – ‘fairness’ to the insured was again the determinative factor ([link](#)). It is noted that AFCA’s more expansive approach to dispute resolution was recently affirmed by the Supreme Court of Queensland in the matter of *Investors Exchange Limited v AFCA Ltd and Lornette Pty Ltd ATF Lornette Superannuation Fund* [2020] QSC 74

²³ See section 12BF of the *Australian Securities and Investments Commission Act 2001*

²⁴ ASIC has observed that “the court must assess the fairness of a term in the context of the contract as a whole. This means that a term could be unfair in one contract but not unfair in another. The court may also consider any other matters it thinks relevant, and will determine whether unfairness arises in a particular contract on a case-by-case basis. See ASIC Information Sheet 210 ([link](#))

²⁵ See section 12BG(3) of the *Australian Securities and Investments Commission Act 2001*

remains substantively unfair.²⁶ In practice, substantive fairness is likely to depend largely upon whether the clause is thought to be reasonably necessary to protect a legitimate interests of the insurer. At a fundamental level, most offset clauses should be justifiable on the grounds that they ensure the principle of indemnity is maintained (i.e. they mitigate against the risk of the insured being financially better off while on claim). However, insurers will need to be mindful that they don't overreach in this regard.

For instance, it is accepted that the receipt of an all-inclusive payment does not preclude an insurer from applying an offset. Most offset clauses contain a mechanism by which the insurer can break down the lump sum into its different components, deem an amount as being in respect of lost income and apply it to the benefit payments made under the policy.²⁷ To date the transparency of the apportionment formula appears to have been the primary determining factor in whether such a clause is fair.²⁸ However, given lump sum awards are predicated on earnings the insured would otherwise be expected to have received for the remainder of their working life, there is arguably some imbalance in allowing the insurer to offset the amount received over a much shorter period. Should this be seen as creating a consequential windfall for the insurer, the clause is at risk of being deemed unfair.²⁹ While administratively efficient, arbitrary lump sum offset periods might want to be reviewed.

Insurers may also need to consider how they deal with situations where an offset clause results in a nil benefit to the insured. As effectively, this results in a situation where the insured has been paying a premium for insurance they are ultimately unable to claim on. It is submitted that this results from a unique and specific set of circumstances, rather than any inherent unfairness in the product design. However, it is noted that the criteria against which AFCA will assess fairness includes whether the product provided the consumer with a reasonable value or benefit?³⁰ ASIC's recent review of TPD insurance and focus on customer outcomes also demonstrates that ultimate product value may be a relevant consideration in future fairness assessments.³¹ Insurers may wish to consider possible design solutions that alleviate the risk of the perceived unfairness in this situation. For example:

- providing the ability for a person to extend their waiting period (and thereby defer the start of the benefit period) to a time when the offset may no longer apply. This aligns with the principle of indemnity and ensures the insured is not overly compensated at any one point in time. There is a risk that this approach could reduce long-term return to work incentives. However, this can be somewhat mitigated by incorporating appropriate rehabilitation and retaining strategies within the extended waiting period.
- allowing a person who cannot claim, because their benefit is fully offset by another policy or statutory compensation scheme, to retrospectively cancel their cover and receive a refund of premiums paid. It would be up to each insurer to determine the appropriate refund period. This essentially represents an extension of the requirement that applies to

²⁶ ASIC has indicated that just because a term is transparent it will not automatically be fair – see ASIC RG220 ([link](#))

²⁷ Turks Legal (December 2020)

²⁸ See for instance *FOS Determination 260207*, where it was observed that although the choice of a 5 year apportionment period for a lump sum amount may seem arbitrary, it remained fair for the offset to be calculated in accordance with the clear terms of the policy.

²⁹ It is noted that some life insurers were recently criticised by consumer groups for their treatment of job keeper payments under offset clauses. While it was accepted, they were technically within their rights to apply an offset when the policy wording allowed, there was some debate over whether it was fair for them to do so and make a profit from the resulting savings on income protection ([link](#))

³⁰ Bright Law (AFCA's Fairness Approach (January 2020) ([link](#)))

³¹ ASIC Commissioner Hughes having observed that the high decline rates for TPD insurance with and Activities of Daily Living assessment required urgent changes to ensure that TPD cover provides real value, stating "Fairness requires as much" ([link](#))

group insurance under the Insurance in Superannuation Voluntary Code of Practice, where an insured member whose default cover is fully offset may apply for a refund of premiums for the lesser of the duration of the overlap of cover, or 6 years.³²

Conclusion

Income protection insurance provides important cover for many Australians who suffer a loss of income because of disability. Offset clauses play a central role in ensuring that the level of financial support provided by these products is both appropriate and sustainable. Although the underlying basis for applying an offset is ostensibly rooted in the common law principle of indemnity, it is important to remember that an insurer's entitlement to do so arises solely from the wording used in the policy.³³ It is not particularly revolutionary therefore to state that an offset clause should be clear, legible and fair. However, the task of the insurer is not an easy one. A considerable degree of pragmatism is required to develop a clause that is liberal enough to ensure the benefit payable will be comprehensively reduced for the effect of other benefits the policyowner is entitled to in respect of their disability, yet remains robust and balanced enough to withstand judicial scrutiny.

³² The Code is not defunct and the stapling provisions which come into force in October this year under Your Future Your Super, will reduce duplicate accounts and duplicate insurance covers (at least inside of super).

³³ Turks Legal (December 2020)