

Dr Shona Batge
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

6 July 2009

Dear Dr Batge

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES: INQUIRY INTO FINANCIAL PRODUCTS AND SERVICES IN AUSTRALIA

The Insurance Council of Australia Limited¹ (Insurance Council) is the representative body of the general insurance industry in Australia. We appreciate the opportunity to provide input to the Parliamentary Joint Committee's inquiry into "the issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses".

Most of the terms of reference for the inquiry do not relate to the general insurance industry. Consequently, the Insurance Council's response focuses on points 8 and 9 of the terms of reference:

8. *The adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers, and*
9. *The need for any legislative or regulatory change.*

The Professional Indemnity (PI) Insurance required by Australian Financial Services (AFS) Licensees

Compensation and PI insurance arrangements for AFS licensees are set out in ASIC's Regulatory Guidance 126 (RG 126). This Guidance explains that:

- (i) Under Section 912B of the Corporations Act, AFS licensees must have arrangements for compensating retail clients for losses they suffer as a result of a breach by the Australian Financial Services Licensee (Licensee) or its representatives of their obligations in Chapter 7 of the Corporations Act.
- (ii) The arrangements must satisfy the requirements in the Corporations Regulations 2001 (Corporation Regulations) which require that Licensees must obtain professional indemnity insurance that is adequate having regard to the nature of the Licensee's business and its potential liability for compensation claims.

¹ The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. March 2009 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross premium revenue of \$31.7 billion per annum and has total assets of \$93.8 billion. The industry employs approx 60,000 people and on average pays out about \$99.2 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

The Insurance Council has consistently supported this approach, subject to PI insurance not being expected or portrayed as offering a guarantee that money will be available to pay compensation awarded to those who have suffered financial loss through a Licensee's breaches of their obligations.

PI Insurance is designed to protect the interests of the insured professional

PI insurance provides cover to the insured professional for losses sustained by third parties as a result of a breach of the insured's professional duty. The policy would react in the event of the insured being sued for professional negligence. This would include most areas of breach under Chapter 7, such as the provision of inappropriate advice and/or non-compliant disclosure documents.

The coverage available from individual insurers can vary. In some circumstances, the policy will be provided as an all encompassing package; in other situations, people may need to seek specific endorsements or separate policies to cover particular risks. For example:

- PI policies may not automatically include fidelity cover (protection for clients against theft or misappropriation) or may only provide cover for third party loss arising from employees' fraud and dishonesty, but not cover any first party loss. This is an important matter of public policy and risk management for the insurer;
- Some PI policies for financial advisers, for example, may specify that liability for any product recommendation that is outside of the Licensee's approved products list is not covered;
- PI insurance cover may include an excess amount above the average claim made by a retail client, meaning that the Licensee would ultimately be responsible for providing compensation not the insurer;
- If there is a widespread issue causing loss to a number of clients, then the claim for each client may each have a separate excess applied. This also results in the Licensee having to meet a significant part of the compensation itself; and
- PI insurance cover generally will not differentiate between wholesale and retail clients, and what is perceived to be acceptable to a retail client in terms of limits could be taken up by one or two large wholesale claims.
- PI insurance generally operates on a claims made basis and only covers claims notified within the policy period. As most advice claims are 'long tail', there is a likelihood that a licensee might have retired or been wound-up and the period for notifying claims to the insurer passed before the client realises they have suffered a loss.

ASIC's Guidance in RG 126

Recognising how PI insurance operates, ASIC has set out in RG 126 that:

"ASIC will administer the PI insurance framework so that, as far as possible, it reduces the risk that retail clients go uncompensated where a Licensee has insufficient financial resources to meet claims by retail clients."²

and furthermore

"However, PI insurance is not a guarantee that compensation will be paid if there is a claim."³

² ASIC, RG 126, page 4.

³ Ibid.

PI insurance is a commercial product, which in this case is designed to protect the financial well being of the insured financial advisor or AFS Licensee. It is not designed to enable compensation to be paid to third parties, although in many cases the money received under the policy is on-paid to third parties enabling a wronged client to be compensated by the financial advisor or AFS Licensee.

When ASIC issued RG 126 in late 2007, it had hoped that the coverage offered by PI insurance would expand in order to maximise the chances of compensation being paid to wronged clients. Consequently, ASIC set out in RG 126 that, at the end of a two year transitional period i.e. from 1 January 2010, the PI insurance required to be held by Licensees would in addition need to cover particular situations where products had been recommended that were not on the Licensee's Approved Product List (APL) and also Licensees would need to have at least one years run-off cover.

It is important to note that a hardening insurance market, exacerbated by the global financial crisis, has negatively impacted the ability of insurers to underwrite higher risk activities. In these circumstances, and given the increasing levels of risk associated with some parts of the financial services sector, some major insurers have tightened their underwriting criteria whilst some have withdrawn from the financial advisor sector of the market altogether.

In the present and projected environment, we are advised by those of our members that offer PI insurance that the availability of PI insurance for financial advisors or AFS Licensees even as currently required by ASIC is becoming scarcer and there is upward pressure on prices. Therefore, it is likely that ASIC's objective that a higher standard of PI insurance cover apply from 1 January 2010 is now commercially unrealistic. Unless ASIC revises its requirements in RG 126, Licensees will need to assess whether they will need to make additional arrangements to complement the protection provided by their PI insurance. The Insurance Council's PI Committee has met several times with ASIC to discuss its guidance in light of developments in the insurance market.

Should consideration be given to a compensation fund?

The Insurance Council and our members believe that PI insurance will continue to play a key role in enabling professional advisors to manage efficiently the risks of carrying on business, so providing money to allow many compensation awards to be successfully paid. However, if the Government's policy goal is to enable consumers to receive in *all* cases the compensation they are awarded, then the Government needs to consider establishing a compensation fund. Such a compensation fund would then act as a safety net for those instances where the client is not able to rely on their Licensee's PI insurance to fund their compensation..

The Insurance Council would be pleased to provide input to a review to identify situations where consumers could potentially be exposed to non payment through inadequate financial resources by a Licensee (for example the financial advisor's or Licensee's intentional wrongdoing, or a series of similar cases where multiple excesses need to be paid). We submit that it is important to identify the scope of the problem (i.e. the actual number of consumers being left uncompensated) so that a compensation fund could be designed appropriately e.g. a fund based on over-estimates of the problem to be addressed would be a burden for the Government to administer and industry to fund, with consumers ultimately paying the costs.

The Insurance Council is aware of interest in adopting the UK Financial Services Compensation Scheme (FSCS) as a model for an Australian compensation fund. Without commenting on the merits of the FSCS, the Insurance Council notes that the Australian Government established in October 2008, a Financial Claims Scheme (FCS) to protect customers of authorised institutions regulated by APRA; e.g. policyholders and third party claimants of a failed general insurer. We submit that it would be unnecessary for an Australian compensation fund to duplicate the protection which the FCS already provides for insurance policyholders and bank deposit holders.

In summary, whilst supportive of the need to consider the advantages of a consumer compensation fund if Government wants to ensure satisfactory compensation is paid in all cases, the Insurance Council submits that the financial services regulatory framework is basically sound. There are no proposals for reform that we would wish to make in the context of the current inquiry.

Please contact Mr. John Anning – Insurance Council’s General Manager – Policy, Regulation on (02) 9253 5121 or janning@insurancecouncil.com.au if you require any further information.

Yours sincerely



Kerrie Kelly
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