INSURANCE COUNCIL OF AUSTRALIA

Statutory Compensation Review
c/-Treasury
Langton Crescent
PARKES ACT 2600
Email: futureofadvice@treasury.gov.au

Attention: Ms Francesca Kibria

24 June 2011

Dear Ms Kibria

REVIEW OF COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES

The Insurance Council of Australia Limited[1] (Insurance Council) welcomes the opportunity to respond to the Consultation Paper for the above review (the Consultation Paper) issued by Mr Richard St John (the Reviewer). The Insurance Council valued the meetings which its members, particularly those that provide Professional Indemnity Insurance (PII), were able to have with the Reviewer in June 2010 and most recently 18 May 2011. We are also appreciative of the additional time provided to make this submission.

The Reviewer has been asked to review and report to the Government on the need for, and costs and benefits of, a statutory compensation scheme for financial services. The holding of such a review was a key part of the Insurance Council's submission to the Parliamentary Joint Committee on Corporations and Financial Services "Inquiry in financial products and services in Australia".

As the Consultation Paper recognises[2], PII operates to ensure in the large majority of cases that Licensees are able to pay compensation awarded against Licensees for breaches of the financial services law. However, the Insurance Council has consistently argued that PII cannot be made to operate as a guarantee that compensation will be paid and if the Government adopts this as a policy goal, there should be serious consideration given to the merits of a last resort compensation scheme. For this reason, the Insurance Council has been very supportive of the Review.

We note that the submission to the Review made by the Financial Ombudsman Service (FOS) on 24 May 2011 (the FOS submission) takes the necessity of a compensation scheme

[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. September 2010 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $33.8 billion per annum and has total assets of $101.5 billion. The industry employs approx 60,000 people and on average pays out about $86 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).

[2] Consultation Paper, page 52.

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as given and provides a well developed model for discussion. Without taking a position on the FOS model, the Insurance Council would prefer to see a thorough analysis of the need for a scheme first before going beyond general principles in commenting on any proposal.

We acknowledge the point that FOS makes on page 5 of its submission that there are clearly cases where consumers do not receive any or even part of the compensation they are awarded. However, in gauging the need for a compensation scheme, it is necessary to have an idea, even approximate, of the extent of the problem in order to assess whether it warrants the establishment of a scheme, with its associated ongoing costs.[3] The Insurance Council understands the difficulties of estimating the amount of compensation that goes unpaid but it would encourage the Reviewer to do further work on this issue.

Please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation (tel: (02) 9253 5121; email: janning@insuranecouncil.com.au), if you would like to discuss further any of the issues covered in this submission.

Yours sincerely

Robert Whelan
Executive Director & CEO

[3] The ASIC report "Compensation for retail investors: the social impact of monetary loss" found that failure to fully compensate investors who lost money because of the conduct of their managed investment scheme or financial planner can cause the investor severe emotional and financial distress. However, without minimising the significance of individual losses, the Insurance Council notes that the Report's findings are based on a small number of investors.

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ATTACHMENT

INSURANCE COUNCIL RESPONSES TO QUESTIONS POSED IN CONSULTATION PAPER

CAPACITY OF PII MARKET TO SUPPLY LICENSEES WITH ADEQUATE PII COVER

- ***The capacity of the insurance market to supply licensees with the PII cover that is adequate to the needs of licensees considering the specific features that ASIC requires the licensee to take into account;***
- ***The circumstances in which the market has been able to provide run off cover;***
- ***The conditions in terms of access and price, for reinsuring the risk of PII provided to licensees;***
- ***Changes in the availability of PII for licensees since 2008;***
- ***The longer term outlook for the insurance market in terms of the supply, cost and coverage of PII; and***
- ***The circumstances in which licensees have found it difficult to acquire PII cover that meets their needs.***

The Insurance Council understands from its members that the insurance market generally has the capacity to provide Australian Financial Services Licensees (Licensees) with PII policies that enable them to satisfy the requirements of Regulatory Guide (RG) 126. Industry feedback is that those Licensees that have difficulties in obtaining PII are likely to have business models or processes that create a higher probability of breach of the Licensee's professional duty of care, or have an adverse claims history. Surprising as it may seem, it is not uncommon for PI insurers to receive applications for PII where it is not clear what financial services the potential Licensee proposes to provide. These are generally taken to be an unacceptable risk.

Run-off cover, from one to seven years, is frequently provided to Licensees that are considered to present a low level of risk (at the time they cease to trade). Conversely, where the insurer considers the risk of the PII cover being triggered is unacceptably high or uncertain (as in the case of a new applicant), run-off cover is not offered. Insurers may be prepared to provide automatic run-off cover to new insureds in the context of a closed or compulsory scheme for a particular profession. In these situations, the guarantee of a particular premium pool from members of the scheme makes the provision of run-off cover a defineable risk. (There are currently no examples of such schemes involving Licensees.)

The global financial crisis in 2008 increased the cost of capital and with it the price of reinsurance cover generally. In relation to PII, it resulted in reinsurers being more selective in the risks they were willing to cover. This was particularly the case for a sector such as financial planning where there had been considerable losses in Australia due to several large scale financial collapses. These developments have been reflected in the pricing of PII.

The Insurance Council would prefer not to speculate on the future state of the PII market. However, we are unaware of any factors that would significantly impact the current availability of PII for licensees.

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INSURANCE INDUSTRY PERSPECTIVE ON PROCESS FOR CLAIMING COMPENSATION

- ***Any practical difficulties arising from the differences between the standards of liability for licensees under Chapter 7 of the Corporations Act, the general law and under EDR schemes, and the ambit of liability covered in PII policies obtainable by licensees.***

A PII policy generally provides the insured with cover (subject depending on the specific policy to particular limits and excesses) for economic losses flowing from breaches of their professional duty no matter the legal source of their liability.

- ***Any issues in practice with compensation claims against licensees by retail clients in regard to the distinction between inappropriate advice or misconduct by a licensee on the one hand and investment losses in the absence of such misconduct on the other.***

A PII policy protects the financial interests in the insured professional. In the absence of a breach of the insured's professional duty of care, will not reimburse insureds for compensation awarded for investment losses.

DATA ON PREMIUMS AND PAYOUTS

- ***The trends in PII premiums taken out by AFS licensees;***
- ***The trends in claims paid under PII held by AFS licensees and the value of claims made under those policies which are still outstanding;***
- ***As a subset of the above, the proportion of premiums received from and claims paid out to, licensees who provide financial advice;***

As explained by Insurance Council members at the 18 May 2011 meeting with the Reviewer, APRA would be the most authoritative source of premium and claims data for PII. If necessary, the Insurance Council would be prepared to canvass members on writing a letter to APRA advising of their support for APRA to provide the Reviewer with access to unpublished data. Subject to the protection of commercial confidentiality, Insurance Council members would be pleased to discuss with the Reviewer or you and your Treasury colleagues the implications of data provided by APRA.

- ***The typical grounds upon which PII claims are not met;***

There a numerous reasons why a claim under a PII policy may not be met either partially or in full and it would be difficult to develop an exhaustive list of all possible scenarios. However, generically speaking, the major causes would be:

- Non-disclosure or misrepresentation of a material fact by the licensee to the PI insurer prior to entering into the PII policy;
- Non-compliance with a condition of the policy by the Licensee.
- Failure to notify claim or dispute in the relevant policy period by the Licensee.
- Application of a policy exclusion.
- Erosion of the limit of indemnity available under the policy.
- Amount of the claim falling within the policy excess (and therefore payable by the Licensee from their own resources)

- ➢ Claims arising out of facts or circumstances known prior to the PII policy being entered into.

- ***The costs and benefits of PII for licensees and the financial services industry more broadly.***

PII generally provides cover for third party loss arising from a breach of professional duty. This would include most areas of breach under Chapter 7 of the Corporations Act, such as the provision of inappropriate advice and/or disclosure documents. It protects the Licensee from financial ruin and provides a level of stability to the wider financial services industry.

PII also provides a tried and tested mechanism for the management of claims against Licensees. PI insurers utilise their experience and knowledge to assist in assessing the merit of individual claims and economics of settlement options.

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 polices to cover particular risks.

For example:

- PII 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 PII 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;
- PII 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
- PII 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.
- PII 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.

VIEWS ON THE COMPENSATION ARRANGEMENTS IN OTHER COUNTRIES

- ***The practical operation of those other arrangements including their costs, benefits and scope, and their effectiveness in contributing to consumer protection and the underpinning of consumer confidence in relevant markets.***
- ***The possible relevance of those arrangements as models for the compensation of consumers of financial services in Australia.***

Insurance Council members have no experience or particular knowledge of the compensation arrangements in other countries and so have no views to put forward.

VIEWS ON THE ISSUES AND REMEDIAL MEASURES CANVASSED IN CHAPTER 5

- ***The nature and extent of any shortfall in the delivery of compensation under current arrangements.***

As explained above, there are a number of situations in which PII does not react to reimburse an insured fully or in part for compensation awarded against them. However, that said, it is the view of Insurance Council members that the largest proportion of situations where PII policies do not reimburse the Licensee concern fraud by the Licensee where they are a one person operation (fraud by an employee or authorised representative being usually covered) or where the Licensee is no longer a going concern.

In relation to the extent of any shortfall in the delivery of compensation, Insurance Council members have previously explained to the Reviewer that they do not maintain records of compensation claims that are not reimbursed to the insured, whether in total or in part. Furthermore, insurers are unable to provide information on the gap between compensation awarded and the compensation claimed by a Licensee's client that has suffered a financial loss.

Members would submit that this shortfall would be difficult if not impossible to measure. It should be understood that the amount claimed by an aggrieved retail client does not necessarily represent their actual loss or the loss caused by the conduct of the Licensee. Indeed, at best, it is the client's perception of their loss. In the absence of an objective assessment of every claim (by the Court or by EDR determination) to determine the actual loss suffered the measurement of any shortfall is impossible. In reality, most disputes are settled by conciliation or mediation and this assessment is never finalised.

- ***The scope for further measures to lift the standards of licensee conduct or assist consumers in looking after their own interest.***

The Insurance Council endorses the initiatives being taken by the Government as part of its Future of Financial Advice reforms to lift the professionalism of licensed financial advisers. The Insurance Council and its members are also actively supporting with their own research and analysis the Government's work to improve the effectiveness of general insurance disclosure to consumers.

- ***A tighter approach to the administration of the requirement to hold PII.***

A number of possibilities under this heading were discussed with the Reviewer on 18 May 2011, for example in relation to a certificate of cover being provided to ASIC on application for and renewal of a Licence. Members explained that insureds were provided annually with

a certificate of currency separate from the renewal. However, this would not provide ASIC with a meaningful summary of the insurance cover; for example the certificate does not show limits, exclusions, or endorsements.

The Reviewer also suggested that as part of the annual licence renewal process the Licensee could advise ASIC of any changes in their PII cover. Members note that such a notification would need to be the Licensee's responsibility as the insurer or broker may change from one year to the next and would not have access to details of the previous year's cover.

- ***The promotion of a standard PII cover including to deal with claims after licensees cease to trade.***

RG 126 already acts as a requirement to have a minimum standard of PII cover, with the Licensee obliged to make supplementary arrangements if they are unable to obtain cover consistent with RG 126. As the Reviewer is aware though, the original requirement in RG 126 for minimum run-off cover to be mandatory from 1 January 2010 had to be amended because such cover was not commercially available. Provision of automatic run-off, as explained above, is only possible within certain scheme arrangements.

- ***Improved disclosure of insurance arrangements and facilitation of third party rights.***

Insurance Council members do not consider that detailed disclosure of a Licensee's insurance arrangements to the Licensee's clients would be helpful to them in assessing the risk of doing business with that particular Licensee. There are several reasons for this:

- practical difficulties in amending disclosure documents each time the insurance or insurer changed;
- as PII is provided on a "claims made and notified" basis any insurance arrangements disclosed at the time a client originally engaged the licensee (or at any point in the relationship) would not necessarily be the arrangements that would apply to a claim made at a later date – such a situation is potentially misleading to the client;
- some insurance arrangements may be relatively complex with more than one insurer on a single policy or multiple insurers on more than one policy;
- in any event, ordinary consumers would not normally be in a position to understand the detail of the insurance being disclosed (members understand this was the conclusion of ASIC when the current requirements were drafted).

It is satisfactory that, as currently required, the consumer is informed that the Licensee has insurance which satisfies the regulatory requirements.

In relation to facilitation of third party rights, as the Consultation Paper notes, section 51 of the Insurance Contracts Act 1984 (the IC Act) enables a third party to recover directly from the insurer if the insured is liable to pay damages and has died or cannot be found after reasonable inquiry. Although it remains to be seen whether the Insurance Contracts Act will be amended to benefit third parties for example in situations where the insured is insolvent, there is State/Territory legislation (such as section 6 of the Law Reform (Miscellaneous

Provisions) Act 1946(NSW))[4] enables a third party to pursue a claim against an insurer in cases of insolvency. In addition, with insolvency, an administrator will have rights to pursue the insurer for reimbursement of compensation claims.

- ***The case for additional requirements in regard to the financial security of licensees;***

Although not an area of direct member expertise, Insurance Council members favour the case for additional requirements being used to strengthen the financial security of non APRA regulated Licensees.

- ***The merits and key design components of a last resort scheme to provide compensation for retail clients, including the approach to industry funding.***

Without the need for a last resort scheme being a foregone conclusion, Insurance Council members had a useful discussion on 18 May with the Reviewer on the possible design of a compensation scheme and possible alternatives. Members recommended that, in considering the need for and design of a compensation scheme, the Reviewer focus on where there is the most significant potential for consumer loss. Although PII operates to ensure that the majority of compensation awards against Licensees are paid, experience with major financial collapses such as Storm and Westpoint show that complaints concerning financial advisers probably present the greatest risk of consumers not being paid their compensation awards.

This reflects not only the particular circumstances of financial advisory licensees (due to the relatively limited financial resources of this sector in comparison to banks and insurance companies) but also the fact that statutory compensation arrangements are already in place for significant segments of the financial services industry[5]. These arrangements have been described pejoratively as “patchwork”[6] and “piecemeal”[7]. However, the Insurance Council recommends that the sector specific arrangements not be so readily dismissed. They were specifically designed for the sectors to which they apply and the Insurance Council is unaware of any analysis that demonstrates significant shortcomings which needed to be overcome by establishing a comprehensive financial services industry wide scheme.

A key concern for Insurance Council members in considering the question of a last resort compensation scheme is the moral hazard that would result from removing all risk from financial decision making. Consequently, in examining the feasibility of a limited compensation scheme focussed on the financial advisory sector, its scope could be made even more manageable by limiting its compensation awards to those products deemed to be suitable for retail investors.

In developing this idea in discussion with the Reviewer, members referred to the concept promoted by ASIC of “investing between the flags”[8]. A retail consumer who, as result of financial advice, invested in products classed as appropriate for retail investors would be able to claim from the compensation scheme if they had suffered financially from the breach

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[4] See also ALRC Report 20 (para 340) per the “Annotated Insurance Contracts Act 4th Edition Peter Mann.
[5] Consultation Paper, page 34.
[6] FOS submission, page 4.
[7] Consultation Paper, page 34.
[8] For example see “Investing between the flags - practical guide to investing” produced by ASIC in November 2009.

of the financial services law and the Licensee did not have the resources to pay a compensation award. In contrast, retail consumers who accepted advice to invest in riskier products “outside the flags” would not be able to claim from the scheme.

As a provider of last resort compensation, it would also be appropriate to cap the compensation paid by a scheme, for example at the maximum levels that FOS can award. If an incentive was felt necessary to minimise moral hazard, last resort compensation payments by the scheme could be further limited to a certain percentage of the scheme’s maximum payment.

Another possibility discussed by members with the Reviewer was a group “gap” scheme involving all licensees from a particular financial services sector, such as financial advisers. The aim of the scheme would be to provide an insurance solution for situations not usually covered by PII such as fraud by the Licensee and run-off. While theoretically possible, the appetite of the private sector to provide such cover at a level of premium that would be affordable is uncertain and an industry body or regulator would be needed to “own” the scheme and administer it.

As explained in the covering letter to this submission, the Insurance Council believes that detailed consideration of the design of a last resort compensation scheme should follow a finding from the Reviewer that there is a need for such a scheme. However, the Insurance Council would like to recognise the detailed work on a possible model that FOS has undertaken in its submission to the Reviewer. The Insurance Council in particular appreciates revision of the proposed scheme to remove cross subsidisation of compensation costs by contribution groups unrelated to the cause of the consumer’s financial loss. This addresses serious concerns that the Insurance Council had on the grounds of moral hazard and equity.