

6 June 2011

Statutory Compensation Review  
PO Box 6295  
Kingston ACT 2604

By email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)

Dear Sir/Madam,

**Re: Review of compensation arrangements for consumers of financial services**

On behalf of the members of the Liability Reform Steering Group (LRSG), we appreciate the opportunity to contribute to the review of compensation arrangements for consumers of financial services (the review).

The LRSG is an informal coalition of professional organisations and firms with a shared interest in liability issues as they impact on members of the professions in Australia. The LRSG was convened in 2002 to discuss the emerging evidence of market failure in professional indemnity (PI) insurance in Australia and the available options for reform to ameliorate this situation. Organisations currently active in the LRSG are listed below<sup>1</sup>, though a number of others have also been involved since the group's formation.

We note that the purpose of the review (as set out in Mr Richard St. John's covering letter) is to review and report to the Government on the need for, and costs and benefits of, a statutory compensation scheme for financial services.

On the need for a statutory compensation scheme for financial services, we do not offer a view. Instead the focus of our contribution is to assist the review with information on arrangements in operation in other professions domestically. We note that the review (at page 73) observes the following:

“4.40 Initiatives to improve the availability and affordability of professional indemnity insurance include the Government's medical indemnity assistance package (aimed at making medical indemnity insurance more available and affordable for doctors), as well as State and Territory professional standards schemes (which allow members of professional schemes to have their civil liability limited in certain circumstances).

“4.41 These initiatives were introduced in response to a perceived market failure in various professional indemnity insurance markets, rather than as primary mechanisms to repay client losses.”

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<sup>1</sup> The Liability Reform Steering Group (LRSG) currently includes representatives of the Australian Institute of Architects, Consult Australia, CPA Australia, Engineers Australia, the Institute of Chartered Accountants in Australia, the Institute of Public Accountants, the Law Institute of Victoria, Professions Australia and representatives of the large national accounting firms, actuaries and the large national law firms.

At page 74, the review invites comment as follows:

“Issues of Interest

“Given the compensation arrangements for financial services in other countries, and in respect to other professions and occupations domestically, views and comments are sought on:

“4.1 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.

“4.2 The possible relevance of those arrangements as models for the compensation of consumers of financial services in Australia.”

As an advocate for the introduction of professional standards legislation (PSL) and with members involved in the development and administration of schemes under PSL, the LRSG is well placed to provide information to the review in response to issue 4.1.

We also wish to offer comment on issue 4.2, and in particular reflect on the exclusion of holders of Australian Financial Services Licenses from coverage by the PSL schemes of the Institute of Chartered Accountants in Australia and CPA Australia.

Information on Issue 4.1 is provided under heading (1) below, whilst issue 4.2 is discussed under heading (2).

**(1) Information on the practical application, costs, benefits, scope and effectiveness of PSL schemes in contributing to consumer protection and consumer confidence.**

Background

In the early years of the past decade, Australia faced a serious and accelerating market failure in professional indemnity (PI) insurance. That is, professionals were unable to obtain adequate, affordable (and, in some cases, any) PI insurance for the full range of services they provided. The events of 11 September 2001, the collapse of local general insurer HIH and the lack of profitability of PI insurance in particular, saw the number of insurers providing PI insurance collapse to a mere handful in Australia at the time.

Insurance, where available, was only available on increasingly restrictive terms. Many professional groups were affected, including engineers, architects, lawyers, accountants, actuaries, audiologists, environmental and pollution remediation services, and so forth.

The consequences of market failure in PI insurance included withdrawal of necessary services, with consumers unable to obtain the services they needed or unable to obtain services backed by insurance. This increased the risk, in the event of something going wrong, that there would be insufficient assets available to compensate a consumer that has suffered financial harm. Professional associations were forced to look at members’ insurance requirements – in some cases reducing their mandatory insurance requirements due to the inability of the market to provide PI insurance to the levels and standards required.

In 2003, federal, state and territory insurance ministers recognised that there was a serious problem. Ministers worked on two essential reforms: professional standards legislation (PSL) and proportionate liability (PL) – both requiring legislative reform to be introduced by all state and territory governments

and complementary federal law reform, in particular changes to the federal Trade Practices Act and other federal laws to give full effect to state and territory initiatives on PSL and PL.

After a thorough examination of the reform proposals, all state and territory governments decided to pass both PSL and PL, and the federal government amended the misleading and deceptive conduct provisions of the Trade Practices Act, the Corporations Act, and the ASIC Act to make state and territory PSL schemes effective under federal legislation.

PSL was introduced to address market failure in PI insurance by:

- Making the risks associated with provision of professional services more predictable and containing the scale of risk to insurable levels
- Providing incentives for professionals to adhere to risk management practices (and related measures including continuing professional education, quality control, adherence to high standards of professional and ethical conduct, and complaints and disciplinary procedures) designed to minimise the risk of claims arising in the first place

Numerous schemes have subsequently been established by occupational associations under PSL across Australia. The website of the Professional Standards Council (the statutory body established under PSL to assess and review schemes) lists 17 professional associations with schemes or scheme applications in progress and a total of 48 schemes operating in jurisdictions across Australia<sup>2</sup>.

#### What is PSL?

PSL is legislation passed in all Australian states and territories (with complementary legislation also passed federally) to provide for the limitation of liability of members of occupational associations and facilitate improvement in the standards of services provided by those members.

The statutory objectives of PSL are<sup>3</sup>:

- (a) To enable the creation of schemes to limit the civil liability of professionals and others
- (b) To facilitate the improvement of occupational standards of professionals and others
- (c) To protect the consumers of the services provided by professionals and others
- (d) To constitute the Professional Standards Council (PSC) to supervise the preparation and application of schemes and to assist in the improvement of occupational standards and protection of consumers.

PSL permits occupational associations to prepare schemes that will limit the occupational liability of scheme members whilst at the same time mandating certain consumer protection measures including maintaining minimum levels of PI insurance and other risk management strategies.

The underlying rationale for PSL is to better protect consumers of professional services and the community generally by facilitating improved professional standards and risk management practices (thereby reducing the incidence of claims) whilst at the same time providing a mechanism that will better safeguard consumers of professional services by improving the availability and affordability of

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<sup>2</sup> See [http://www.lawlink.nsw.gov.au/lawlink/psc/ll\\_psc.nsf/pages/psc\\_schemes#current%20schemes](http://www.lawlink.nsw.gov.au/lawlink/psc/ll_psc.nsf/pages/psc_schemes#current%20schemes)

<sup>3</sup> See Professional Standards Act (NSW) 1994, section 3

PI insurance (thereby increasing the likelihood that resources will be available to compensate a consumer that has suffered financial harm or loss as a result of a professional's wrongdoing).

Hence, it is not correct to regard PSL as just a response to market failure in PI as opposed to a mechanism to repay client losses (paragraph 4.41 of the review cited above). Better consumer protection is a fundamental objective of PSL.

It is true however that there are differences between PSL as a consumer protection mechanism and some other approaches canvassed in the review. This is highlighted by the occupational liability to which PSL does not apply. PSL does not apply to liability for damages arising from:

- The death of or personal injury to a person
- A breach of trust
- Fraud or dishonesty<sup>4</sup>

Consumer protection under PSL is premised on the view that actual recovery of losses suffered by a claimant is best achieved when there is a valid PI insurance policy in place that will enable payment of damages<sup>5</sup>. It should be noted that most, if not all, PI insurance policies will not respond to a claim arising from fraud or dishonesty on the part of the insured.

PSL schemes set threshold limits set in monetary terms under which all successful claims continue to be paid in full (that is they are not subject to limitation under the scheme). Under the legislation, this monetary threshold cannot be less than \$500,000. However, to ensure that consumer claims are paid in full rather than being subject to limitation under schemes, the PSC has (in the case of new schemes approved in recent years) raised the minimum threshold to at least \$1 million.

As an example of how PSL schemes can improve consumer protection, schemes applying to members of the Institute of Chartered Accountants in Australia and CPA Australia have resulted in the minimum PI insurance requirements for members of these associations doubling, increasing from \$500,000 to \$1 million since the commencement of their new schemes (from October 2007).

Depending on how a scheme is designed and structured, claims above the threshold amount may (but not necessarily will) be subject to limitation by a court. Some schemes set an overall limit or cap applicable to scheme members (which may vary according to the size of a firm as determined by number of principals or by fee income or the type of service provided), others have set an overall cap (which may vary depending on the type of service provided) with a sliding scale of liability below this level set as a multiple of the fee for the service giving rise to the claim.

Liability limits are set with reference to claims experience and insurance data (including the level and number of claims against members of the profession and information on the cost and availability of PI insurance) with a view to ensuring that consumer claims as well as the vast majority of total claims will continue to be met in full (that is, they will not be subject to capping) whilst also aiming to ensure that PI liability risk remains commercially insurable.

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<sup>4</sup> See Professional Standards Act (NSW) 1994, section 5

<sup>5</sup> PSL also allows schemes to provide that business assets may be used, either in combination with or as an alternative to PI insurance, to meet claims made against scheme members. In practice most schemes mandate PI insurance, although the business assets provision enables flexibility in the level of deductible permitted.

Schemes are reviewed and assessed by the PSC, an independent statutory body consisting of persons appointed by the Attorney General in each state and territory. Public consultation is undertaken on each scheme submitted for approval. Schemes must be approved by the Attorney General. Avenues exist under the law for appeals against the validity of schemes.

Before approving a scheme, the PSC must consider the following<sup>6</sup>:

- (a) All comments and submissions made to it (pursuant to the public advertisement of the scheme required by law)
- (b) The position of persons who may be affected by limiting the occupational liability of members of the occupational association concerned
- (c) The nature and level of claims relating to occupational liability made against members of the occupational association concerned
- (d) The risk management strategies of the occupational association concerned
- (e) The means by which those strategies are intended to be implemented
- (f) The cost and availability of insurance against occupational liability for members of the occupational association concerned
- (g) The standards determined by the occupational association concerned in relation to insurance policies.

In addition to providing claims and insurance information, professional and occupational associations that apply for schemes under PSL must satisfy the Professional Standards Council that they have appropriate risk management mechanisms and oversight of members. This includes matters such as the following:

- Setting appropriate educational and/or competency pre-requisites for membership
- Requiring members to undertake compulsory continuing professional education and development
- Providing risk management education for members
- Setting and enforcing codes of professional and ethical conduct
- Establishing complaints handling and investigation processes
- Establishing disciplinary processes for members
- Establishing processes to ensure members comply with professional requirements
- Undertaking quality reviews of members' practices, including their risk management procedures
- Providing annual returns and reports to the Professional Standards Council on risk management practices and initiatives

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<sup>6</sup> See section 10 of the Professional Standards Act (NSW) 1994. Similar provisions exist in professional standards legislation in other jurisdictions.

- Establishing processes to monitor insurance claims against members with a view to identifying areas for further risk management

By requiring such measures as a pre-condition for schemes, PSL benefits consumers by facilitating better professional standards and enhanced risk management. The PSL model provides incentives for better adherence by professionals to risk management. By linking risk management to ceilings on liability limits, not only are professionals provided with real incentives to adhere to professional requirements by PSL, associations are given significant leverage to impose high standards on members.

Furthermore, risk management under PSL has the following advantages:

- Independent review and assessment of risk management practices – PSL requires professional associations or other occupational groups to submit their risk management strategies to the PSC for evaluation prior to schemes being approved
- Greater accountability on the part of professional bodies and occupational groups for the risk management processes they impose – associations are required to report annually on the risk management programs they have implemented for members and on the effectiveness of these programs
- Greater transparency of risk management programs – information on schemes is available to the public and the PSC publishes an annual report
- PSL enables comparative benchmarking between professions and between occupational groups and facilitates exchange of information and knowledge between them
- PSL achieves a consistency and simplicity of regulation of professions and other occupational groups that are otherwise absent.

Insurers have indicated strong interest in PSL as a means to improve standards across professions.

The greater transparency of risk management under PSL is in the interest of consumers and should assist in encouraging insurers to recognise that professions and other occupational groups with such schemes are better insurance risks.

#### The benefits of PSL and its effectiveness in contributing to consumer protection and the underpinning of consumer confidence

PSL was introduced as one of two key reforms to address market failure in PI insurance. As noted by Trowbridge Deloitte, the insurance benefits of capping liability were expected to be two-fold:

- Establishing a high degree of certainty about the potential size of claims, in effect removing the possibility of extremely large claims arising from a small firm or relatively small assignment (noting that there was general consensus amongst insurers and reinsurers when writing excess business that they are more concerned about the risk of a large individual claim rather than a series of smaller claims during a year)
- Potentially reducing the average size of claims because of the application of the caps<sup>7</sup>

Significant premium savings were expected to accrue to professional advisers through the first of these benefits, the reason being that high levels of “catastrophe” excess covers would not need to be purchased. The reduction in demand for such high levels of cover could also free up insurers capital, enabling it to be redeployed to make lower layers of cover more available and more affordable in due course.

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<sup>7</sup> Trowbridge Deloitte “Professional Indemnity for Advisers – Impact of Proportionate Liability and Capping”, November 2002

Due to the long-tail nature of PI insurance claims and the relatively short time that most schemes have been in operation, it is not possible to categorically attest to the success of PSL as a measure that has corrected market failure in the PI insurance market. It is noteworthy however, that with the exception of financial services (which is specifically excluded from coverage under PSL schemes – see below) the PI insurance market for non-medical professions in Australia has been relatively stable in recent years, despite the impact of the GFC and other events (natural disasters etc) that have impacted on the supply of capital to the global insurance market. The cyclic softening in this market that might have been expected to have manifested by now has largely not occurred, suggesting that the introduction of PSL (and PL) has in fact achieved its intended aim.

Other benefits can however be identified now:

#### *Benefits for consumers*

- Provides a high level of comfort for consumers of professional services that the professional with whom they are dealing holds appropriate PI insurance or other assets, increasing the likelihood that in the event a claim arises, resources will be available to meet that claim.
- Consumers will be sure that the professional with whom they are dealing is a participant in ongoing risk management strategies, which gives assurance of the professional's competence and commitment to standards.
- Consumers benefit by having recourse to a complaints system in the event of being dissatisfied with the professional's service.
- PSL also offers the benefit of more rigorous oversight and application of measures designed to prevent professional negligence from occurring.
- PSL makes professional associations more accountable for their self-regulatory measures, as well as making such self-regulatory measures more transparent. This provides greater surety and confidence to consumers and to the providers of PI insurance for professionals. The link to liability caps provides incentives for diligent application of risk management by professionals.
- PSL benefits the wider community by enabling continuing access to a complete range of professional services, including many vital services which were regarded as high-risk and for which affordable insurance cover was difficult to obtain.

#### *Benefits for professional and trades people*

- Professionals benefit because PSL provides a balance between risk and reward that provides security to professionals and the protection they need to be able to continue to practice by enabling the risks of professional practice to be covered by affordable PI insurance.

The LRSG strongly supports PSL and its policy objectives. In our view PSL is an efficient means to improve protection for consumers of professional and occupational services, by improving standards of professional conduct and facilitating enhanced risk management. At the same time, by mandating that PI insurance and/or business assets be held by PSL scheme participants to prescribed levels, the prospect that there will be adequate assets available to compensate successful claimants for their losses, at levels designed to meet consumer claims and the vast majority of total claims, is increased. Indeed, actual recovery of damages by plaintiffs is likely to be higher under a system of PSL than it would be in its absence.

**(2) Comment on the possible relevance of PSL arrangements as models for the compensation of consumers of financial services in Australia, especially in light of recent PI insurance experience in the financial services sector**

As noted above, PSL may not be a complete solution as a model for the compensation of consumers of financial services in Australia, as PSL schemes do not apply to claims arising from fraud or dishonesty. It may also be the case that not all market participants would be able to be members of a PSL scheme. An alternative (and perhaps less expensive) approach to protecting consumers that you may wish to consider could be to require all market participants who provide financial advice to retail clients to be members of an occupational association that has an appropriate PSL scheme, with a statutory compensation scheme then only needed to cover situations where loss has occurred through fraud or dishonesty.

There is no reason the PSL model could not apply to financial service professionals who are members of occupational associations that meet the requisite standards for a scheme under PSL.

It is interesting to note that members of CPA Australia and the Institute of Chartered Accountants in Australia (ICAA) who are Australian Financial Services License (AFSL) holders are excluded from the schemes of their respective associations. No services provided by entities that hold AFS licenses are subject to limitation of liability under the schemes.

The reason for this blanket exclusion is two-fold.

Firstly, when the three professional accounting bodies (CPA Australia, ICAA and the then National Institute of Accountants) were discussing their prospective new PSL schemes with Federal Treasury (and other federal authorities, including ASIC) at a roundtable meeting in March 2007, concern was expressed about whether it was appropriate to cap liability arising from financial advice to retail clients. At the time, ASIC had not finalised its work on appropriate compensation and insurance arrangements to apply to AFSL holders (work subsequently released as RG 126).

Treasury communicated to the professional accounting bodies in April 2007 advising:

“Section 912B of the Corporations Act requires that financial services licensees have arrangements for compensating retail clients for loss or damage suffered because of breaches of the relevant obligations under Chapter 7 by the licensee or its representatives. A draft regulation which would complement this requirement was exposed for public comment in late 2006. If implemented, it would require professional indemnity insurance, with the possibility of other approved arrangements, and APRA regulated bodies being exempt. Until this work is completed, Treasury will not be in a position to determine either an appropriate cap, or even if a cap should apply in relation to financial services.”

Whilst the accounting bodies then focused on amending their schemes in such a way to exclude financial advice to retail clients, subsequent advice provided by Treasury from the Australian Government Solicitors office (confirming advice from the NSW Crown Solicitors office) was received to the effect that they did not consider that a scheme could be established in such a way that it applies only to certain activities of the persons covered by a scheme. A scheme might be expressed to only apply to a class of persons within an occupational group but it cannot be expressed in terms that it only applies to certain activities undertaken by that group or by a specified class of persons within that group. PSL would need to be amended to provide for such an outcome.

Accordingly, the only course of action open to the accounting bodies to accommodate Treasury was to exclude the entire class of persons who hold AFSL from coverage by their schemes, even though this covers a much broader class of services than Treasury was originally concerned about.



Whilst amendment of state and territory PSL is not the subject of the review, the question needs to be asked whether retail consumers of financial advice have been well served by the exclusion of AFSL holders from PSL schemes.

The information presented in the review's Consultation Paper on the performance of PI insurance for financial advice in comparison to PI in other segments suggests that consumers have not been well served by this exclusion. A similarly poor picture is painted if one looks at the statistics presented in the Consultation Paper on actual recovery of damages by claimants seeking compensation for losses arising from financial advice in breach of the adviser's obligations.

It is a moot point whether PI insurance for financial advice may have been more readily available and less expensive had at least some members of this market segment (namely those AFSL holders who are members of the professional accounting bodies) been able to participate in PSL schemes.

However it is far from clear that any benefit has resulted to consumers from their exclusion.

Whilst ASIC would appear to have struggled to set PI insurance requirements that the commercial insurance market is capable of meeting, members of the professional accounting bodies that belong to PSL schemes have had to raise their insurance to a minimum of \$1 million (and up to \$20 million or \$75 million depending on the services provided by their firm), whilst also meeting the risk management requirements that PSL entails.

It may be that not all AFSL holders belong to occupational associations that would be able to establish PSL schemes, as the requirements are onerous. However, we believe that it is timely to revisit the exclusion of AFSL holders from coverage by PSL schemes so that those professionals who belong to professional associations that have schemes can benefit from the schemes, for the benefit not only of those members but also for the benefit of the consumers of financial services.

Yours sincerely,

A handwritten signature in black ink that reads "Michael Coleman". The signature is written in a cursive, flowing style.

Michael Coleman  
Chairman  
Liability Reform Steering Group