ASIC

Australian Securities & Investments Commission

Compensation and insurance arrangements for AFS licensees

Regulation impact statement (RIS)

November, 2007

What this regulation impact statement is about

This Regulation Impact Statement (RIS) addresses ASIC's proposed policy to administer the compensation requirements for Australian financial services licensees in s912B of the *Corporations Act 2001* (Corporations Act). In this RIS, the requirements in the Corporations Act and Corporations Regulations 2001(Regulations) are referred to as the **compensation requirements**.

ASIC's aim is to administer the compensation requirements to maximise their potential to achieve the objective of reducing the risk that Australian Financial Services (AFS) licensees cannot meet retail client's claims for compensation because they do not have sufficient financial resources.

ASIC published Consultation Paper 87 *Compensation and insurance arrangements for AFS licensees* (CP 87) on 23 July 2007 consulting on how we will administer the compensation requirements. We received around 20 submissions from stakeholders on the various policy proposals set out in CP 87. We also met separately with a number of industry associations. ASIC has taken these submissions into account in preparing this RIS.

In developing our final position, we need to consider the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

- the aims of the legislation of reducing the risk that successful compensation claims by retail clients cannot be met by the relevant licensees due to lack of available financial resources; and
- facilitating activity in the financial services industry, including not unreasonably burdening licensees.

This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

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Issues

Background

Compensation requirements

1. Section 912B of the Corporations Act requires financial services licensees providing financial services to retail clients to have arrangements for compensating those clients for loss or damage incurred as a consequence of breaches of the Act by the licensee or its representatives. The compensation arrangements must meet the requirements of the Regulations or have been approved in writing by ASIC.

2. While s912B was introduced as part of the *Financial Services Reform Act 2001*, the effect of this provision was deferred to give the Australian Government time for further review and consultation on proposed regulations to specify the requirements.

3. Regulation 7.6.02AAA was inserted by the Corporations Amendment Regulations 2007 (No 6) and commenced on 1 July 2007. The Regulations provide for a transition period so that the obligation to have compensation arrangements in place commences from:

   - the date of commencement of their licence for licensees whose licence commences on or after 1 January 2008; and
   - 1 July 2008 for licensees whose licence commenced before 1 January 2008.

4. The Regulations require that licensees have adequate professional indemnity (PI) insurance cover. The Regulations set out factors that must be considered in order to determine whether the PI insurance cover is ‘adequate’. However, the definition of what is adequate has been left to ASIC guidance. In announcing the Regulations to complement s912B, the Parliamentary Secretary to the Treasurer announced that ‘the regulations will be supplemented by ASIC guidance’, (Media Release 028: *Financial Services Licensees’ Compensation Arrangements Announced [29/06/2007]*).

5. Under the Regulations, certain categories of licensees that are regulated by the Australian Prudential Regulation Authority (APRA) are exempt from the requirements under the Regulations because of their capital adequacy requirements.

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6. Under s912B, ASIC can approve alternative arrangements to PI insurance. The Corporations Act and the Regulations prescribe certain factors that ASIC must take into account. Section 912B requires ASIC to consider the financial services covered by the licence and whether the arrangements provide the equivalent of run-off cover. The Regulations require ASIC to have regard to whether the coverage is adequate based on the same factors applied by the Regulations to PI insurance.

7. Regulation 7.7.03A also requires licensees to include a statement in their Financial Services Guides (FSGs) and the FSGs of their representatives about the kind of compensation arrangements they have in place and whether they comply with s912B.

8. Under previous transitional compensation arrangements (under reg 7.6.02AA and ASIC's AFS licence conditions) some licensees were required to lodge and maintain a security bond with ASIC. ASIC has the discretion to discharge this security bond and return it to the licensee where the licensee has PI insurance or alternative compensation arrangements.

Objectives of the compensation requirements

9. When it introduced the regulations, the Australian Government described the objective of the compensation requirements as to:

> 'reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources', *Compensation Arrangements for Financial Services Licensees, Regulation Impact Statement*, April 2007 p. 7.

10. In any industry, from time to time clients might suffer loss due to inappropriate advice or other misconduct by a service provider. Individual service providers or firms might not have sufficient resources to meet claims arising from these losses. In the financial services industry there needs to be a mechanism to ensure that funds are likely to be available where retail clients suffer loss due to breaches by financial services licensees of their obligations under the legislation.

11. Therefore, we consider that the compensation requirements are intended to be a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources. In this RIS, we refer to this as the **policy objective.**

ASIC's proposed regulation

12. In considering its policy to administer the compensation requirements, ASIC followed the following process:

    - *Stage 1:* We participated in the stakeholder consultation on the draft regulations to complement s912B.
    - *Stage 2:* We conducted research into the market for PI insurance for financial services licensees.
    - *Stage 3:* Following the announcement of the Corporations Amendment Regulations (No 6) 2007, we published CP 87 proposing that the requirement that PI insurance be 'adequate' means that it is fit for achieving its policy objective as far as practically possible. We also set out our more concrete thinking on what is an adequate PI insurance policy in terms of the amount of cover, scope of cover and terms of cover. Our proposals were intentionally quite specific to promote discussion of how the new requirements would work in practice.
    - *Stage 4:* We reviewed feedback to CP 87 and conducted further targeted consultation with stakeholders. We modified our proposal based on this feedback.

Stage 1: Consultation on the draft regulations

13. The Australian Government consulted on the draft regulation and received about 30 submissions (comments closed 30 November 2006). The Australian Government also chaired a round-table on 17 January 2006, where industry and consumer representatives discussed their submissions. ASIC made a submission and participated in the industry round-table. ASIC has considered the submissions on the draft regulations in preparing this RIS.

Stage 2: Research into the market for PI insurance

14. ASIC commissioned a report on the PI insurance market is currently available for financial services licensees and on the approach licensees take to obtaining PI insurance and the costs to their business, see REP 107 *Compensation arrangements for financial services licensees - Research into the professional indemnity insurance market* (PII Market Report). A copy of this report is published on the ASIC website at www.asic.gov.au.[1]

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[1] The data in the PII Market Report is based on results from a written questionnaire provided to a selection of insurance companies, insurance brokers, underwriting agencies and FICS, meetings with respondents to the questionnaires and a survey of 53 randomly selected financial services licensees.

15. The PII Market Report indicated that the PI insurance market is competitive in terms of price but not in terms of widening of terms and conditions or a reduction in excesses. In other words, licensees may have difficulty in obtaining cover that has a broader scope than that generally available. New standard terms and conditions might be negotiated for a probable increase in insurance premiums.

16. The PII Market Report suggests that the PI insurance market is currently 'soft' with the number of suppliers of this insurance at an all time high[2]. The PII Market Report suggests that the overall market pricing is currently low and premiums have dropped[3].

Stage 3: ASIC consultation

17. ASIC published CP 87 on 23 July 2007 to consult on its proposed policy to administer the compensation requirements.

18. In CP 87,we set out proposals on what is adequate in terms of the amount of cover, scope of cover and terms and conditions, including:
    - minimum cover at least equal to the External Dispute Resolution (EDR) scheme jurisdictional limit on claims;
    - minimum aggregate cover of $2 million with an increasing sliding scale based on revenue;
    - cover for EDR scheme awards;
    - run-off cover for as long as commercially available; and
    - where a PI insurance policy is not 'fully adequate', the licensee could supplement the insurance with additional financial resources for the purpose of satisfying the requirements. This was to be calculated based on comparing 3-month net cash flow projections against estimated amounts payable in compensation.

19. We also proposed that we would approve alternative arrangements only if they gave 'no less protection than adequate PI insurance cover'. We set out a list of consumer warnings for licensees to include in Financial Services Guides (FSGs).

20. We received around 20 submissions from stakeholders on the various policy proposals set out in CP 87.

[2]There were approximately 35 underwriters insuring professional indemnity (based on figures from APRA) and 377 insurance brokers arranging PI insurance (based on figures from the National Insurance Brokers Association) at December 2006.
[3] Respondents to a survey conducted for the PII Market Report indicated that their current premiums were between 0.65% and 2% of income.

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21. ASIC also consulted with a number of industry associations (representing different groups of licensees affected by the compensation requirements) who made submissions to CP 87. We sought more detailed feedback on their submissions made and the key issues affecting different types of licensees. In particular, we sought feedback on what features of PI insurance are generally available to financial services licensees.

22. The key issues raised by the consultation are discussed in the Consultation section of this RIS.

Stage 4: Review of feedback and policy development

23. Based on the feedback received in the consultation process, we modified our proposal as follows:

    - We have proposed an implementation period standard of PI insurance based on what we understand is currently available and will accept this as adequate during a two-year implementation period.
    - We have not proposed a minimum per claim limit.
    - We have not proposed run-off cover during the implementation period and only propose a minimum of one year of run-off after that.
    - We will encourage licensees to state in their FSGs only that they have PI insurance or alternative arrangements or an exemption and whether those arrangements cover past licensees.

24. We have published a Feedback Summary Report highlighting the key issues that were raised in consultation and our responses. See REP 112 *Report on submissions to CP 87 Compensation and insurance arrangements for AFS licensees*, which is available on our website at www.asic.gov.au.reports.

Financial services market

25. The financial services industry is the third largest sector in the Australian economy, generating more than $A67 billion, contributing 7.8 per cent of GDP, providing jobs for approximately 300,000 employees and creating 1.5 jobs in associated industries for every job created in financial services.[4]

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[4] Sources: Invest Australia, *Australia – A global financial services centre, benchmark report*, August 2007, Reserve Bank of Australia: www.rba.gov.au and Australian Bureau of Statistics: www.abs.gov.au.

26. ASIC administers the licensing regime for financial services providers. According to the ASIC licensing database as at 18 October 2007, there were 4,685 licensees registered with ASIC.[5] Of these, approximately 3921 licensees or 83% were authorised to provide advice to retail clients and approximately 68% of licensees were authorised to provide personal advice to retail clients.

27. Approximately 56% of licensees had revenue of $1 million or less. Approximately 2,704 (58%) had PI insurance. However, this includes some licensees who will be exempt under the new requirements and some licensees who do not provide financial services to retail clients.

28. Of the licensees that had PI insurance, approximately 51% had premiums of greater than $25,000, 13% between $15,000 and $25,000 and 22% between $5,000 and $15,000. (Note: In the PII Market Report, premiums are considered to be a poor indicator of availability, as they do not take into account the varying levels of indemnity and terms and conditions attaching to those premiums.) Approximately 21% of licensees had an indemnity level between $1 million and $1.9 million, 25% between $2 million and $4.9 million and 25% between $5 million and $9.9 million.

Claims against financial services licensees

29. The APRA National Claims and Policy database as at December 2006 indicated that the largest cause of loss for PI insurance is categorised as 'advice', for which the average cost per claim is $146,000. The PII Market Report indicates that the types of claims are different for different licensees:

    - Insurance brokers: the main cause of claims is errors and omissions, particularly administrative errors such as the failure to place cover or pass on premiums.
    - Financial planners: inappropriate advice accounts for 80.3% of the complaints received by FICS in relation to financial planners. Other complaints against financial planners relate to the standard of service (8.1%), misrepresentations (7.3%) and non-disclosure of conditions or warnings (4.2%).
    - Stockbrokers: advice and fraud. Stockbrokers are particularly subject to multiple claims for advice.

[5] This information is based on the latest figures reported to ASIC. Most information was provided to ASIC in licence applications and this information has only been updated since in a minority of cases.

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30. The PII Market Report also outlined the following more general causes of loss:

- Acting outside the approved product list (insurance cover is generally not provided for this).
- Advisers switching a client from one fund or product to another without explaining the risks and benefits.
- Fraud and misappropriation of clients' money (insurance cover is not available for fraud by the principal for public policy reasons).

What is the issue/problem being addressed?

Limitations of PI insurance cover

31. One of the key issues raised in the PII Market Report and consultation was that PI insurance is not designed as a compensation mechanism but to protect insured parties against certain risks. The nature and coverage of PI insurance is also limited by what the PI insurance market will provide. Therefore, the ability of PI insurance to achieve the policy objective is subject to practical limitations. These can have a material impact on the effectiveness of the PI insurance cover as a mechanism to compensate consumers.

32. ASIC has identified a number of issues challenges that must be considered if PI insurance is to achieve the policy objective. The challenges relate to both inherent limitations and current market limitations. The challenges include:

(a) issues about the scope of losses that PI insurance is likely to cover; and

(b) issues about whether PI insurance is available as a source of funds to licensees when it is needed to cover a loss by a retail client.

(a) Scope of losses covered

33. PI insurance policies that cover all consumer losses falling within the scope of the obligation under s912B might not be commercially available to all licensees. Commercially available policies might also include significant exclusions that undermine the effectiveness of the policy cover. The PII Market Report's key findings include that:

- there are currently no policies available that are explicitly based on the obligation for AFS licensees to hold PI insurance; and

- current policies might not cover the full range of breaches under the Corporations Act (e.g. there is generally no cover available for fraud by the licensee, representatives acting outside the scope of authority of licensees and products not on an 'approved product list').

(b) Availability of insurance as a source of funds

34. We understand that where the licensee or representative has ceased its business or the business has become insolvent there is a high risk that retail clients' claims against the licensee or representative will be uncompensated. ASIC records suggest that this is a main source of uncompensated claims and a major area of concern in Westpoint investigations.

35. Whether the arrangements will continue to cover persons after the licensee ceases carrying on business and the length of time the cover will continue is a factor that ASIC must take into account in assessing alternative arrangements under s912B(3)(b). Therefore, Parliament clearly regards this cover as important.

36. However, the PII Market Report and industry feedback suggest that there are significant gaps in the coverage of currently available PI insurance policies in these circumstances:

    (a) There is not a ready market for run-off cover and run-off cover can generally only be obtained for 12 months for orderly wind-downs and not for involuntary insolvency. (Run-off cover provides cover for claims made after the insurance policy has ended which have arisen from incidents during the period of insurance cover).

    (b) Membership of EDR schemes generally ends when a licensee becomes insolvent or no longer has a licence. The EDR scheme will then only have jurisdiction over claims notified before the licensee becomes insolvent.

    (c) Policies generally have an excess that an insolvent licensee may be unable to pay.

    (d) Policies have a fixed limit of indemnity, which can be quickly exhausted where there are numerous claims resulting from the same incident or a few unrelated large claims.

    (e) PI insurance policies are generally 'claims made' policies, which means that the claim must be made and notified to the insurer by the insured within the policy period. In the event of financial difficulties, a licensee may fail to promptly notify claims.

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(f) As most advice claims are long-tail[6], there is a risk that the licensee may 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.

Proposed ASIC guidance

37. In CP 87, we discussed some of the issues about the limitations of PI insurance set out above and practical options to improve the effectiveness of PI insurance as a compensation mechanism. We encouraged licensees and the insurance industry to look at practical ways to help s912B PI insurance policies function as effectively as possible in the event of licensee insolvency; and also to provide as strong a risk management tool for the licensee as possible.

38. Some submissions suggested that there was insufficient time for the insurance industry to develop new PI insurance products to meet the compensation requirements before the commencement of the compensation requirements. Time is needed for underwriters to develop policies and to have them approved by reinsurers. Policies generally only come up for renewal once per year and are settled by insurers even further in advance. These submissions recommended that ASIC give relief for a further transition period of at least one year.

Competing needs for certainty and flexibility

39. Industry feedback expressed the desire both for certainty about the requirements and flexibility within the regime. Insurers and industry groups viewed ASIC's proposals as too prescriptive. Consumer groups and FICS considered that it was important for ASIC to set minimum standards in the industry. Other AFS licensees wanted ASIC to develop standard policy wording with insurers so that they could be certain that the insurance policy they obtained would comply with the requirements. This raises the issue of the level of guidance should ASIC give to strike the right balance between accommodating industry's desire for certainty and the intended flexibility of the regime.

[6] The APRA National Claims and Policy Database suggests that the majority of payments of claims are made in respect of incidents that occurred 2 to 7 years previously (PII Market Report p. 23).

Cover in a 'hard' PI insurance market

40. We understand from the PII Market Report and consultation that the PI insurance market is cyclical and that we are currently in a competitive or 'soft' stage of the cycle. This may mean that the standards of cover that are available now when the market is soft may not be available or may be prohibitively expensive in harder markets in the future.

Issues for ASIC guidance

41. If ASIC issues policy guidance that an adequate PI insurance policy should include certain terms and conditions that are not generally available in the market, this may increase premiums for licensees or licensees may be unable to comply with this standard. However the fact that insurance is in a 'soft' competitive market may present an opportunity to create a market for policies that better achieve the objectives of the regime.

42. If a licensee is unable to obtain adequate PI insurance, its only other alternative under the legislation is to apply to ASIC to approve alternative arrangements. If ASIC does not approve alternative arrangements, the licensee will not be in compliance with its obligations. In this case, ASIC may revoke the financial services licence and require the licensee to cease trading as a licensee.

43. In December 2003, the Australian Government stated in *Compensation for Loss in the Financial Services Sector - Position Paper* that if a licensee cannot obtain PI insurance cover because the business it operates under its licence is excluded (e.g. agri-business and, tax-effective schemes), then it should seek to have the licence limited so that it aligns with the compensation coverage.

Objectives

44. ASIC's aim is to administer the compensation requirements to maximise their potential to achieve the objective of reducing the risk that licensees cannot meet retail clients' claims for compensation because they do not have sufficient financial resources. We also acknowledge that there are practical limitations in using PI insurance for this purpose.

45. Therefore, we seek to balance:

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- the aims of the legislation of reducing the risk that successful compensation claims by retail clients cannot be met by the relevant licensees due to lack of available financial resources, and
- the desirability of facilitating activity in the financial services industry, including not unreasonably burdening licensees.

46. The need to strike an appropriate balance between stakeholders is part of ASIC's aim (as reflected in ASIC's Statement of Intent) to ensure guidance meets the highest standards of usefulness and effectiveness.

Options

47. Prior to publishing CP 87, ASIC considered alternative ways to administer the compensation requirements to address the issues discussed above. Below we set out:

- the proposal adopted in CP 87;
- other alternatives we considered but did not pursue; and
- our recommended option after consultation.

Option 1 – adequate means fit to achieve the policy objective, as far as practically possible

48. This is the proposal we adopted in CP 87. We proposed that licensees should obtain the cover that we considered adequate to meet the policy objective, with the expectation that industry would develop new products to meet this standard. Submissions from industry were critical of the level of prescription in ASIC's policy and suggested that the proposed standard of cover was not generally commercially available.

Option 2 – do nothing

49. One option is to leave it to licensees to interpret the compensation requirements without ASIC guidance. However ASIC will still need to develop its own view internally as to what is 'adequate' in order to administer the compensation requirements and decide whether or not to grant a licence in a particular case. As outlined in ASIC's Statement of Intent, we think it is desirable that ASIC policy is transparent to the market.

Option 3 – give best practice guidance only

50. This option relies on licensees complying with the spirit of the principles based regulation. Under this option, ASIC would set out

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broad detail on the process of assessment that we consider licensees should undertake and highlight factors for licensees to consider. However, there is a risk that 'best practice' guidance without a level of detail will not achieve 'adequate' standards.

Option 4 – adequate means what is commercially available

51. Under this option we would consider that 'adequate' is what is commercially available based on the premise that the Government would not have intended licensees to obtain something that is not available. There is an argument that this was the intention behind the Regulations, otherwise licensees may not be able to comply with the compensation requirements without approval from ASIC. Based on what we understand is reasonably commercially available, we would outline some minimum standards for licensees to comply with.

Option 5 – require licensees to self-insure to cover gaps

52. This option was also proposed in CP 87, in combination with Option 1 above. This option adopts the approach used by the Financial Services Authority in the UK[7] – that where cover cannot be obtained for certain areas or where a policy has significant exclusions, licensees need to cover this gap using their own resources (e.g. similar to excesses or deductibles) in an insurance policy. The broader the exclusions in the policy the more additional financial resources a licensee would need. The aim of this option is to give licensees the flexibility to use their own funds to supplement their PI insurance so that their compensation arrangements may be adequate overall.

53. We think that the requirement for licensees to have adequate financial resources to cover PI insurance gaps is implicit in the requirement to have 'adequate' PI insurance in the Regulation. Having adequate resources (to cover amongst other things, gaps in PI insurance cover) is also arguably part of the obligation to ensure the financial services are provided efficiently, honestly and fairly under s912A(1)(a) and to have adequate financial resources to provide the financial services under s912A(1)(d). AFS licensees are already required to have adequate financial resources to provide the financial services covered by their licence and to carry out supervisory arrangements (under s912A(1)(d)). ASIC has also set financial requirements in *Regulatory*

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[7] See the guidance in the *FSA Handbook – Interim Prudential Sourcebook: Investment Businesses* IPRU(INV) and *Frequently Answered Questions*.

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Guide 166: Licensing: Financial Requirements (RG 166) to help ensure that licensees comply with their obligations in s912A.

54. RG 166.19 states that the requirements in RG 166 are not designed to ensure that licensees can cover compensation claims because there is a separate requirement under s912B. However, we think that it is reasonable for licensees to assess whether or not they need additional liquid funds on top of these requirements based on the kind of insurance policy that have obtained and whether it has a high excess and substantial exclusions.

Option 6 – defer implementation

55. As recommended in some submissions to CP 87, we considered deferring the commencement of the compensation requirements until 1 January 2009 so that industry could negotiate new policies and industry associations could set up group arrangements.

Option 7 – two-stage implementation

56. This is our recommended option. Under this option, ASIC would take a staged approach to administering the compensation requirements:

- *Stage 1:* for an implementation period of two years we will require licensees to have a PI insurance policy in place that has certain minimum policy features based on what we understand is generally commercially available currently (the 'implementation period policy') and we will consider this to be adequate during the implementation period. (This reflects Option 3 (*adequate means what is commercially available*) discussed above.)
- *Stage 2:* after the implementation period, we will require licensees to have a PI insurance policy in place that is adequate to meet the policy objective. (This reflects Option 1 (*adequate means fit to achieve the policy objective, as far as practically possible*) discussed above and the position adopted in CP 87.)

57. At both stages, we would require licensees to ensure they have sufficient financial resources to cover the excess and any significant gaps in cover and retain records of this assessment. (This reflects the thinking behind Option 5 (*require licensees to self-insure to cover gaps*).)

58. This option aims to balance the consumer protection requirement of having a minimum standard of compensation arrangements in place as soon as possible and the feedback from the submissions that what

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we consider to be adequate PI insurance is not currently commercially available.

59. During the implementation period we would continue to work with industry to develop insurance products that meet the policy objective. Licensees would require a significant transition period to comply with such a staged approach, as insurance policies would come up for renewal at different times. We consider that a two-year transition period (i.e. to 31 December 2009) would be required.

60. As part of this option ASIC could continue to meet with industry representatives to encourage them to take a key role in the regime, including educating their members about PI insurance, setting standards and guidelines, possibly arranging standard form cover and where appropriate considering alternative arrangements for their members (such as group insurance policies and fidelity funds etc). ASIC could also continue to meet with insurer representatives to work towards establishing standard policies that better meet the policy objective.

Impact analysis

Affected parties

61. Parties affected by the proposed policy would be:

(a) financial services licensees;

(b) consumers of financial services;

(c) providers of PI insurance;

(d) ASIC and the Australian Government;

(e) relevant industry bodies; and

(f) EDR schemes including the Finance Industry Complaints Scheme (FICS) and Insurance Brokers Disputes Scheme (IBD).

Costs and benefits of each option

Qualifications

62. We sought feedback in CP 87 on the likely compliance costs, effects on competition and the other impacts, costs and benefits of our proposals. We asked for both quantitative and qualitative information where possible. We received very little quantitative information. We understand it is costly for industry to obtain this data. However, the

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lack of quantitative data provided response to CP 87 means it has been difficult for ASIC to assess the quantitative costs and benefits of our proposals.

63. The quantitative data discussed in this section of the RIS has been obtained from the PII Market Report and ASIC's licensing database. Both of these sources reflect the insurance that was available and the market conditions before the compensation requirements commence. After the compensation requirements commence, the insurance industry will price the risk of various licensees seeking insurance cover and possibly develop standardised insurance products reflecting these risks. Previous experience of the introduction of new mandatory insurance requirements (e.g. the introduction of the insurance requirements under the superseded *Insurance (Agents and Brokers) Act 1984*) suggests that insurance premiums will be higher initially, while the insurers gain experience in pricing the risks. Licensees may have to pay premiums equivalent to around 5% of their revenue and some more marginal operators will be unable to obtain insurance at a commercially realistic price (and may have to have an alternate arrangement approved or cease business).

64. Therefore, the various options for ASIC regulation that we have considered necessarily involve costs that will be determined under the future insurance market for AFS licensees. It is difficult to estimate these costs based on the available data that reflects the current insurance market.

65. The costs will also vary significantly between different categories of licensees. For example, the insurance industry has experience in pricing the risk for insurance brokers and we understand that a higher standard of PI insurance cover is generally available for insurance brokers. However, insurers have less experience in pricing risks for the financial planning industry.

66. The costs will also vary significantly based on the licensee's individual circumstances. The compensation requirements require a licensee to consider their own business needs in determining what is adequate PI insurance. We also understand from the PII Market Report that insurers determine the terms and conditions, levels of premium and excess under which the insurer will undertake the risk based on a risk assessment of the licensee's business. Therefore, the same standard of insurance cover may cost more for a high-risk licensee than a licensee assessed as a lower risk.

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67. Therefore, the data relied upon in the following analysis has limitations.

Costs to licensees consistent for all options

68. Certain costs imposed on licensees are generally consistent across all options.

69. **Initial and ongoing assessment costs:** Licensees must undertake an initial assessment of their business and have a process of ongoing assessment. This will involve staff costs to review the business and risk profile, to meet with insurance brokers, review the policy of insurance initially and annually or when there is a change in business. However we anticipate that this will involve minimal incremental costs, as licensees are already required to have risk management processes in place.

70. **Minimum cost of PI insurance:** The PII Market Report indicates that minimum premiums are around $1000. However the minimum premium for a particular licensee may be higher than this based on the insurer's risk assessment of the licensee. We also consider that policies obtained for this premium are unlikely to be adequate for almost all licensees. There is also a cost in staff time to obtain insurance cover.

71. **Cost of applying for alternative arrangements:** Licensees who wish to have alternative arrangements approved by ASIC will incur the cost of preparing the application to ASIC and ASIC fees associated with the application (likely to be approximately $1000). In addition ASIC is likely to ask for an actuarial report to assist in its assessment of whether the alternative arrangements provide no less protection than adequate PI insurance cover.

72. **Cost of approved guarantees:** Related licensees of licensees who are exempt under the Regulations can apply to have a guarantee from the exempt licensee approved by ASIC. Feedback on CP 87 suggests that this option is unlikely to be used by licensees in practice because of the capital adequacy requirements of exempt licensees. However, if a licensee sought ASIC approval, there is likely to be an application cost of approximately $1000.

73. **Cost of updating FSGs:** Submissions to CP 87 suggest that there will be cost involved in updating and printing FSGs to provide the additional disclosure required by the compensation requirements.

Option 1 – adequate means fit to achieve the policy objective as far as practically possible

Costs - licensees

74. This option would require licensees to obtain PI insurance along the lines proposed in CP 87. Submissions to CP 87 suggested that the likely compliance costs of this option would be high across industry. Some submissions suggested that the costs would outweigh the benefits by lessening competition and increasing compliance costs.

75. Submissions suggested that direct costs include the cost of purchasing additional insurance cover. Licensees who already have insurance cover are likely to face increased premiums when obtaining the cover required under this option. Licensees are also likely to incur greater staff costs in finding compliant insurance (estimated to be approximately two days of senior manager's time, although more time may be required).

76. There is also a high risk that the insurance market will not create new products and insurers may exit the market if they are unwilling to provide cover meeting the requirements. This might mean only large, low-risk licensees would comply and ASIC would refuse a number of licences or cancel others, where the licensee cannot obtain cover. Cover may also become less available in a harder insurance market. Submissions suggest that this will lead to reduced competition in the financial services market.

77. The features of the insurance policy required under this option and the costs of obtaining insurance with these features are discussed below.

78. **Amount of cover:** Licensees would be required to have a minimum aggregate claim limit of at least $2 million if their total revenue from retail clients of financial services is $2 million or less. Licensees with total gross revenue greater than $2 million, would be required to have a minimum aggregate claim limit approximately equal to their actual or expected revenue from retail clients, up to a capped minimum of $20 million cover.

79. This proposal will give rise to costs, as licensees will have to pay more for higher levels of cover. The ASIC licensing database indicates that approximately 36% of licensees (approximately 1413 licensees) who provide advice to retail clients do not have any PI insurance at all. The PII Market Report suggests that premiums are between 0.65% and 2% of turnover/revenue. Based on this data, licensees with revenue of $1 million, half of which is from retail

clients, would need $1 million cover and would have insurance premiums in the range between $6,500 and $20,000. A licensee with revenue of $3 million from retail clients and a total revenue of $5 million would require insurance cover of $3 million and would have insurance premiums in the range between $32,500 and $100,000. (We understand that insurance cover for retail client claims only is not currently available). These premiums may also be higher due to the minimum scope of cover we would set and the risk profile of the licensee.

80. The ASIC licensing database also indicates that approximately 22% of licensees (approximately 594 licensees) currently have PI insurance but have less than $2 million cover. These licensees would need to obtain a higher amount of cover. However, the PII Market Report indicates that there is not a linear relationship between the amount of cover and the premium. The PII Market Report survey suggests that a doubling of the limit would typically cost a 30% premium increase (so for a licensee with revenue of $1 million, there would be a requirement of cover for $2 million with a premium of about $20,000, where formerly they have had $1 million cover at a premium of about $15,400 – an increase of about $4600). Some licensees may also have PI insurance cover greater than $2 million but less than their revenue from retail clients. These licensees would also be required to obtain a higher limit of indemnity.

81. **Scope of cover:** Licensees would be required to obtain a PI insurance policy that would cover loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 of the Corporations Act. We understand that there are currently no insurance policies specifically tailored to cover this risk. As discussed above in paragraph 63, premiums are likely to increase as the insurance industry gains experience pricing this risk and may rise to 5% of revenue (i.e. for a licensee with revenue of $1 million, total premiums may be $50,000).

82. **Activities covered:** The policy must cover the licensee and all of its representatives. The PII Market Report indicates that cover for employees and agents is generally available but cover for representatives is mixed. Some insurers require a specific endorsement to be taken out to cover representatives, which may attract an increase in premium.

83. **Automatic reinstatement:** Licensees are also required to have one automatic reinstatement so that if the limit of indemnity is exhausted, the cover is automatically reinstated for the balance of the policy

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period to cover any new claims. We understand that insurance policies with this feature are widely available; therefore, the cost of this feature is likely to be included in the cost of insurance premiums (discussed above) for most licensees. If the licensee exhausts its limit of indemnity and needs to use the automatic reinstatement, this will cost another year's premium.

84. **Excess/deductible:** The excess must be at a level that the business can confidently sustain as an uninsured loss, taking into account the licensee's financial resources. In the PII Market Report, excesses ranged from $5000 to $250,000. ASIC's licensing database suggests that approximately 44% of licensees providing personal advice to retail clients have excesses of $9999 or less. Excesses are typically around 1% of fee income. The higher the excess, generally the lower the insurance premium. However, licensees will bear the cost of the excess if a successful claim is made. For example, if a reasonable estimate of claims for a licensee in a particular industry sector is one claim with an excess of $100,000 per year, they would need to ensure that they would have $100,000 per year available to pay the excess, otherwise the insurance policy will not be adequate. The Financial Services Authority (UK) estimates that the cost of capital for personal investment firms is 'no more than 5.5% of the capital held' (reflecting the cost of unsecured loans less the return that could be made if the capital were liquid assets) and uses this figure to estimate the cost of holding additional financial resources in the UK.[8]

85. **Legal costs:** Defence costs must be 'in addition' to the minimum aggregate claim limit or the level of cover must be sufficiently increased to take into account defence costs. The PII Market Report indicates that defence costs typically comprise 30-50% of a claim. Currently most policies have defence costs in addition, so licensees would pay the premiums discussed above under 'amount of cover'. However, if defence costs are inclusive, then licensees may have to obtain around double the limit of indemnity. This would lead to approximately a 30% increase in premiums.

86. **EDR scheme awards:** The policy must cover EDR scheme awards. The PII Market Report indicates that insurance policies do not generally cover EDR scheme awards unless a specific endorsement is obtained. We do not have any data on the cost of this endorsement. Its availability will depend on which EDR scheme the licensee is a member of and the jurisdictional limit of that scheme.

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[8] Financial Services Authority, *Consultation Paper 193: Professional Indemnity Insurance for personal investment firms: proposed policy and rules*, July 2003, p. 51.

87. **Fraud/dishonesty/infidelity:** The policy must cover fraud/dishonesty by the principal where the principal is a corporate licensee (i.e. except for sole traders) and fraud/dishonesty/infidelity by agents (including representatives). We understand that the availability of this insurance cover is inconsistent. Some policies specifically exclude this cover. We anticipate that obtaining this cover is likely to involve an increase in insurance premiums for most licensees.

88. **Approved product list:** The policy must cover items not on an approved product list in legitimate switching cases where the client is being switched from one fund or product that is not on the approved product list to another. We understand that this cover is not currently generally available and is likely to involve an increase in insurance premium.

89. **Retroactive cover:** If the licensee had a previous PI insurance policy, the policy must provide retroactive cover from the date of expiration of the previous policy. We understand this is generally available and should not involve an increase in insurance premiums for most licensees.

90. **Run-off cover:** The policy must have run-off cover for as long a period as is reasonably practicable, but at least one year. The PII Market Report and submissions we have received suggest that this cover is generally only available to certain groups of highly capitalised, lower risk licensees. ASIC's licensing database suggests that 50.4% of licensees who provide personal advice to retail clients had some run-off cover at the time they applied for their licence, although we do not have information about the period of run-off. Generally, run-off cover costs 90% of the previous year's premium. Some licensees may be able to obtain 7 years of run-off cover for 350% of the previous premium. The run-off cover requirement is likely to increase premiums for most licensees.

91. **Financial resources:** In addition to the financial resources required to cover excesses (discussed at paragraph 84), we understand that licensees may obtain a policy with a gap in cover and cover this gap using their own resources. The cost of covering this gap will depend on the licensee's assessment of a reasonable estimate of the likely number and amount of claims that would not be covered by the insurance.

Costs - consumers

92. The cost of increased premiums would be passed on to consumers, increasing the cost of financial services generally and reducing the

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options for consumers to obtain financial services. Licensees can increase prices for their services to offset their increased costs to an extent because significant numbers of other suppliers may also face increased costs and demand is not perfectly elastic. The market for financial services is also opaque and fragmented.

Benefits - licensees

93. The reputation of the financial services industry may be improved if there is better compensation available for consumers. The insurance may also help licensees to remain in business and minimise impact on their profitability despite large successful claims being made against them because the insurance will supplement their financial resources. Insurers may commence offering PI insurance that incorporates ASIC's guidance, creating a market for such a policy and eventually leading to reduced premiums for these standard term policies.[9]

Benefits - consumers

94. This option prescribes a minimum standard of PI insurance cover. This protects consumers, who can be confident that all licensed financial service providers will have, at least, this minimum standard of cover. By requiring a minimum standard of cover it is more likely that consumers' claims will be paid out. Consumer confidence in the financial services industry would also be improved.

95. It is difficult to obtain data on what proportion of consumer claims would be paid by the licensee in the absence of the option 1 minimum standard of PI insurance cover. This means it is difficult to obtain quantitative data on the exact benefit of option 1. However, the qualitative benefits of the minimum standard of PI insurance cover required under this option are outlined below.

96. **Amount of cover:** The PII Market Report suggests that a limit of indemnity of $2 million would cover 90% of *individual* claims. Therefore setting a minimum of $2 million aggregate cover is likely to provide a benefit in compensation available for consumers, although the extent of the benefit will depend on the frequency of coincidence of claims. Setting an increasing sliding scale of minimum cover based on revenue sets a higher standard of consumer protection and reflects that $2 million cover may be insufficient where there are *multiple* claims arising from one incident.

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[9] Based on evidence from the PII Market report, there is currently a 'soft' market. It may therefore be a good time to renegotiate standard terms in PI insurance policies to provide more flexibility.

97. **Scope of cover:** Chapter 7 of the Corporations Act imposes many obligations on licensees to protect retail consumers. Insurance cover to provide additional resources where a licensee breaches these obligations provides an important benefit to consumers. (However, this benefit is created by legislation that requires this scope of cover, rather than by ASIC regulation.)

98. **Exclusions:** We require licensees to have insurance policies that do not contain exclusions from cover that would erode consumer protection including claims for misrepresentations to clients (a key area of loss).

99. **Activities covered**: The PII Market Report and ASIC's records indicate that fraud by representatives is a key area of consumer claims and a major gap in current insurance coverage. Therefore, coverage of fraud will benefit consumers. (However, this benefit is created by the legislation, which requires coverage of fraud, rather than by ASIC regulation).

100. **Automatic reinstatements:** An automatic reinstatement provides the benefit that if there are unexpected multiple claims in one year, the licensee can have access to another full limit of indemnity in that year. This will ultimately benefit consumers

101. **Excess/deductibles:** Requiring licensees to have sufficient resources to pay the excess on the insurance policy, increases the likelihood that the policy will be available to compensate consumers.

102. **Legal costs:** Defence costs of 30-50% of a claim may cause a licensee to be unable to cover the cost of the claim if these costs are not provided for under the insurance policy limit of indemnity. Therefore, requiring coverage of defence costs will ultimately benefit consumers.

103. **EDR scheme awards:** EDR schemes are the main venue for consumer compensation claims. Therefore, requiring insurance to cover these EDR scheme awards provides an important safeguard for consumers. It is difficult to estimate the extent to which PI insurance is required to pay these EDR scheme awards but licensees with less financial resources or multiple claims may not be able to cover these claims without PI insurance.

104. **Fraud/dishonesty/infidelity:** Fraud is a key cause of consumer claims for loss in the financial services industry. Therefore, requiring coverage of fraud will ultimately benefit consumers. (Ideally, from a consumer protection perspective, a policy should cover fraud and

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infidelity of the insured principal, including a sole practitioner. However, this cover is unlikely to ever become available as it creates a moral hazard.)

105. **Approved product list:** This is another key area of loss. Ideally all acts outside the approved product list would be covered but this is unlikely to ever become available. However, advice on switching products is a key are of loss and a key gap in insurance cover. Coverage of this area will, therefore, provide an important consumer protection benefit.

106. **Retroactive cover:** Retroactive cover ensures that there is no gap between PI insurance policies and therefore provides an important benefit to consumers.

107. **Run-off cover:** Run-off cover provides a benefit to consumers because it covers previous licence holders who have ceased business. APRA has observed in administering the National Claims and Policy Database that most insurance payments are made within 2 to 7 years of the incident giving rise to the claim. Without run-off cover, consumers who bring claims within this period will go uncompensated if the licensee has ceased business during this time. Insurance is most likely to be required where a licensee is in financial difficulty or insolvent. We acknowledge that run-off cover will provide limited benefit to the consumer if the licensee is required to pay the premium at this time.

Benefits - ASIC

108. This option provides greater transparency about ASIC’s expectations of licensees and greater consistency in ASIC’s decisions. This option also fulfils general expectations in the industry that ASIC will provide guidance on the level of excess and exclusions that are acceptable. It may also discourage requests for ASIC to ‘approve’ individual licensee’s PI insurance cover.

Option 2 – do nothing

Costs - licensees

109. Without guidance, licensees may be uncertain about how to effectively comply with the compensation regime. As a result of this uncertainty there may be increased legal and compliance costs for licensees in interpreting the compensation requirements.

110. Further, without express guidance, licensees are likely to approach insurance brokers and obtain whatever standard cover is provided by

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their insurance broker without negotiating out of the standard terms where required. This may not be adequate for compliance with the compensation requirements. Indirect costs may result if licensees obtain policies with overly restrictive terms or policies that do not sufficiently meet the licensee's needs (e.g. where there is a greater proportion of the compensation being paid from the licensee's own funds).

Costs - consumers

111. Without guidance there may be a low standard in the PI insurance policies of licensees. As a result there may be less compensation protection for consumers. A lack of guidance may also cause a misconception among consumers about the level of protection offered by the compensation requirements.

Costs - ASIC

112. There may potentially be increased costs in enforcement as ASIC will not have issued publicly transparent policy on what it considers to be adequate PI insurance. Without a formally published policy, there may be an inconsistency in the application of what ASIC considers to be adequate PI insurance. There may also be an increased cost to ASIC in assessing applications for alternative arrangements without a consistent, published and transparent policy.

113. Furthermore, ASIC's reputation may suffer if it does not provide guidance or the regime is not implemented adequately.

Benefits - consumers

114. This option may lead to lower compliance costs for licensees and this may be passed on to consumers in lower prices for financial services. There will also be greater flexibility for licensees to put in place arrangements that meet the individual needs of their business. However we consider that these benefits will be outweighed by the lower standard of insurance that may not assist licensees who have insufficient resources to cover all successful claims made against them.

Option 3 – give best practice guidance only

Costs - licensees

115. Providing best practice guidance would not give licensees sufficient certainty that the arrangements they put in place will comply with the law. There may be some increased premiums and additional compliance costs to licensees if they analyse their own requirements

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without guidance on minimum standards. Licensees may also incur indirect costs if they choose an amount of cover that is inadequate for their circumstances. Furthermore, licensees may have to negotiate different terms and conditions in standard insurance policies at the cost of increased premiums. (We note that the additional compliance costs to licensees if they analyse their own requirements is unlikely to be significant considering that the law requires licensees to analyse their requirements even if ASIC sets a minimum.)

Costs - consumers

116. A lower standard of PI insurance may be adopted generally within the industry and this will increase the likelihood that consumer claims are uncompensated.

Benefits - licensees

117. This option gives licensees greater certainty about ASIC's interpretation of the requirements, than option 2. In particular, highlighting certain terms and conditions in policies that would undermine the adequacy of the policy would be beneficial in assisting licensees to obtain cover that meets their needs. In some circumstances, this may also reduce the risk of non-compliance, thereby reducing potential ongoing costs. Less staff time may be required to obtain insurance, as licensees may be able to obtain standard insurance policies offered by brokers.

Option 4 – adequate means what is currently commercially available

118. This option is likely to involve higher insurance premiums than Option 2 (*do nothing*) and Option 3 (*give best practice guidance*) because licensees will not be able to rely on standard policies provided by insurance brokers and will incur the costs of negotiating terms and conditions of insurance that meet ASIC's requirements, for an increase in premium. However, this option is likely to involve lower insurance premiums than Option 1 (*adequate means fit to achieve the policy objective as far as practically possible*) because it is based on what is commercially available. As for Option 1, the cover we prescribe may not be available in a harder insurance market and may not be available to some sectors of licensees (e.g. small independent planners), who would be forced out of the market.

119. The features of the insurance policy required under this option and the costs of obtaining this insurance cover are discussed below.

Costs - licensees

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120. **Amount of cover, scope of cover, persons covered, automatic reinstatement, excess/deductible, legal costs and EDR scheme awards, retroactive cover**: We would require the same standards as for Option 1. See paragraphs 78-86 and 89 for a discussion of the cost impact.

121. **Fraud/dishonesty/infidelity**: We would require the insurance to cover fraud of representatives, employees and agents (except for acts outside the approved product list). We understand that this cover is generally available, so we anticipate that this requirement will have a minimal and significantly lower impact on premiums than the requirement under Option 1 at paragraph 87.

122. We would not impose requirements for cover for acts outside approved product lists and run-off cover. Therefore under this option licensees would not have the cost impact discussed in paragraphs 88 and 90.

Costs - consumers

123. There is a risk to consumers that the insurance may be later found to be inadequate. Licensees accepting sub-optimal policies as 'adequate' transfers risk to consumers, in that where licensees are unable to pay claims due to inadequate PI policies, consumers will likely suffer loss. There is also a risk that there is no incentive to develop new insurance products that meet the policy objective.

Benefits - licensees

124. This option provides a compromise position between Options 1 (*adequate means fit to meet the policy objective*) and Option 3 (*give best practice guidance*) as licensees will have more flexibility than under Option 1 but have added certainty of the minimum standards prescribed by ASIC. This option should also retain close to the current level of competition in the market.

Benefits - consumers

125. This option can achieve some improvement in current protection for consumers in that all licensees will obtain a minimum standard of cover, which is likely to be higher than under Options 2 and 3.

Benefits - ASIC

126. This is a pragmatic approach that implements the compensation arrangements without further delay.

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Option 5 – require licensees to self-insure to cover gaps

Costs - licensees

127. Ideally an insurance policy would not have exclusions from cover so that the licensee is adequately protected for all relevant acts. However, our research and consultation suggests that in many circumstances insurers will not provide cover for certain activities of a licensee or certain kinds of claims for risk management reasons.

128. A policy that contains such exclusions or a high excess may also be sold at a lower premium because the licensee bears more of the risk. For example, a licensee who provides, amongst other things, advice on derivatives, but obtains a policy that excludes liability for derivatives, would have to pay any successful claims relating to derivatives out of their own funds. Licensees would therefore need to hold additional financial resources to cover these gaps in their cover. The incremental cost of assessing what financial resources are needed should be low. We consider that assessing what financial resources are required is good business practice and a current requirement of licensees' risk management obligations.

129. The cost of holding additional financial resources to cover the cost of the excess/deductible is discussed above at paragraph 84. As with the excess, the cost of additional financial resources to cover exclusions will depend on:

- the extent of the exclusion from cover;
- the risk profile of the licensee and its risk management structures (as these affect the likelihood of excluded claims being brought);
- lower insurance premiums reflecting the exclusions in cover; and
- the cost of capital and the return if the capital was otherwise invested.

130. Smaller licensees who cannot afford to self-insure to cover the gaps in their cover and cannot obtain cover that does not have these gaps, may be forced out of the market.

Costs – consumers

131. This option may encourage licensees to obtain lower levels of PI insurance cover and higher excesses because they can choose to self-insure for a greater amount. If licensees do not accurately assess the additional financial resources they require, consumers may be uncompensated for claims brought that fall within the gaps in insurance cover. Also if a licensee becomes insolvent, any additional financial resources will go into the general pool of funds to pay creditors. However, some degree of provision for these risks may

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assist a licensee to continue as a going concern where successful claims are made against it. Smaller licensees, who cannot afford to self-insure to cover the gaps in their cover and cannot obtain cover that does not have these gaps, may be forced out of the market, leading to reduced choice for consumers.

Benefits – licensees

132. Licensees may be more likely to obtain adequate cover at an affordable price if they can substitute capital for higher levels of excess and policy exclusions. This may also be important in a harder insurance market. Licensees may also spend less time trying to obtain compliant cover. However this option is most likely to benefit larger highly capitalised licensees only.

Benefits - consumers

133. This option may lead to a higher standard of compensation overall, because there is some provision for claims where a licensee's insurance policy alone does not provide adequate protection. Also licensees who cannot obtain adequate PI insurance because of the exclusions in cover offered by insurers have the flexibility to supplement the insurance with their own capital and therefore stay in business. Greater competition and more businesses in the market may assist the availability of financial services for consumers.

Option 6 – defer implementation

Costs

134. We understand that many licensees currently have no PI insurance and therefore the current situation does not provide an adequate level of compensation for consumers. There is a risk that some claims by consumers made during the period of any further deferral will go uncompensated due to a lack of financial resources and compensation arrangements of the licensee.

Benefits

135. This option would provide time for industry associations to negotiate group arrangements, which may ultimately offer better protection in the long term. Many submissions to CP 87 suggested that the current transition period under the Regulations is insufficient and licensees have not had sufficient certainty of the requirements to be in a position to comply from commencement.

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Option 7 – two-stage implementation

136. As discussed above, this option involves adopting Option 4 (*adequate means what is currently commercially available*) for the first two years and then adopting Option 1 (*adequate means fit to achieve the policy objective as far as practically possible*).

Costs - licensees

137. For the implementation period (i.e. until 31 December 2009), we anticipate that the cost impact on licensees will be the same as for Option 4 discussed above at paragraphs 120-122. After the implementation period, we anticipate that insurance premiums will increase closer to the levels discussed for Option 1 at paragraphs 74-91. However, as the insurance market would have had an additional two years of experience pricing the risks in this market, insurance premiums may decrease. This decrease is difficult to estimate with any certainty due to the cyclical nature of insurance markets. In a harder market the premiums may increased.

138. There may be increased costs to licensees in obtaining a new policy rather than being able to continue to renew the implementation period policy after two years. Some of this cost is the same for all options, as all licensees are required to have an ongoing process of assessment of their insurance requirements.

Costs - consumers

139. There is a risk that insurance policies obtained in the implementation period are later found to be inadequate and leave consumers uncompensated. The implementation period will not require licensees to have run-off cover, cover for products not on the approved product list and fraud of the licensee. Consumers will therefore not be protected in these circumstances, as compared with the higher standard of protection under Option 1.

Benefits - licensees

140. This option ensures that a minimum standard of compensation arrangements are in place within the timeframe prescribed by the Regulations. It also allows industry time to develop a higher standard of insurance policy, without forcing many licensees out of the market due to the lack of availability now. It takes into account the short implementation period for these requirements, reducing the compliance burden on financial services businesses.

Benefits - consumers

141. During the implementation period, consumers will benefit from increased protection compared to the protection currently available. This is because the amount of cover required during the implementation period is generally greater than the cover currently held. Additionally, PI insurance held during the implementation period must cover breaches of Chapter 7 of the Corporations Act, EDR scheme awards and fraud of representatives, employees or agents. Currently, licensees generally do not have this cover.

142. After the implementation period, consumers will benefit from increased protection compared to the implementation period through the inclusion of run-off cover, cover for products not on the approved product list and fraud of the licensee in licensees' PI insurance policies.

Consultation

143. As outlined above, prior to the release of CP 87, we consulted with the Department of Treasury and industry representatives who made submissions to the draft regulation (including financial services industry associations, consumer associations, plaintiff lawyers, EDR schemes and insurers). We also consulted with insurer representatives separately about the availability of features of PI insurance.

144. On the basis of this consultation and the findings of the PII Market Report, ASIC published CP 87 on 23 July 2007, which set out our proposed policy to administer the compensation requirements. CP 87 was published on ASIC's website and publicly announced by Information Release. ASIC invited written and oral comments on our proposed policy and asked for quantitative and qualitative information.

145. The consultation period ended on 14 September 2007. ASIC received around 20 written submissions from stakeholders including AFS licensees, industry, investor representatives and regulatory bodies. The submissions indicated that many in the financial services industry were looking for certainty from ASIC about the approach it will take in administering these requirements.

146. The main issues raised in the submissions related to:

- our proposal on adequate PI insurance. Overall, respondents believed that ASIC's proposed scope of cover is not commercially available. Insurers and industry groups, in

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particular, viewed ASIC's proposals as too prescriptive. Consumer groups and FICS considered that it was important for ASIC to set minimum standards for the industry. Other licensees wanted ASIC to develop standard policy wording with insurers so that they could be certain that the insurance policy they obtained would comply with the requirements;

- our proposal on partially adequate cover. Submissions expressed concerns that this proposal would impose a significant financial burden on licensees that would be passed onto consumers and did not take into account the licensee's risk management procedures. There was also feedback that making provision for additional financial resources is currently a standard and necessary part of PI insurance because insured parties are required to have resources to cover the deductible applying to their cover;
- assessment of alternative arrangements. Most submissions agreed with our proposal. Some submissions suggested that it is problematic to assess alternative arrangements against PI insurance and that alternative arrangements would need to be assessed in the context of limitations of PI insurance cover and the specified minimums. Further submissions suggested that alternative arrangements should be compared with commercially available PI insurance, as this would change over time, rather than against adequate PI insurance;
- disclosure to consumers. Many submissions were very negative on our proposal to set out a number of 'mandated' statements due to the risk of consumer confusion, increased updating costs and the risk of increased claims. Some submissions expressed the view that consumer-warning messages would not be effective in achieving the aim of the disclosure; and
- timing of commencement of the requirements. Some submissions expressed concern that there is insufficient time for the insurance industry to develop new PI insurance products to meet the requirements.

Conclusion and recommended option

147. ASIC considers that Option 7 (*two stage implementation*) is the preferable option. We consider that this option best achieves our aim of maximising the potential of the compensation requirements to meet the policy objective. We think this option balances the consumer protection aims of the legislation and facilitating activity in the

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financial services industry. This option gives industry time to develop products and solutions that meet the policy objective, while ensuring there is a minimum standard of PI insurance in place in the meantime. By considering what is currently available in our implementation period policy, we can achieve some improvement in current protection for consumers in the market now and retain close to the current level of competition in the market.

148. We have modified the approach taken in our compensation paper (Option 1 - *adequate means fit to achieve the policy objective, as far as practically possible*) based on industry feedback by allowing for an implementation period before licensees are required to have this level of cover. We considered that requiring licensees to comply with what we considered to be adequate without an implementation period would create a risk that the insurance market will not create new products and both insurers and licensees may exit the market. Smaller licensees may be unable to obtain cover, leading to less competition in the market.

149. We have adopted Option 4 (*adequate means what is commercially available*) as our implementation period policy. We have also adopted features of Option 5 (*require licensees to self-insure to cover gaps*) as we recognise that financial resources are a part of PI insurance and should be considered as a factor in assessing the adequacy of PI insurance cover. We have given guidance that licensees should assess whether they have sufficient financial resources to cover the excess of the their PI insurance policy and gaps in cover depending on their risk profile and retain records of this assessment. In CP 87, we proposed that licensees could use a 3-month cash flow assessment to calculate these financial resources. However, we now propose to give licensees flexibility as to how they measure financial resources, whether by capital, cash flow, support from a parent or other alternative.

150. We do not recommend Option 2 (*do nothing*) based on industry feedback that licensees are looking for some certainty as to how to interpret the compensation requirements. We do not recommend Option 3 (*give best practice guidance*) because we consider that it will be important to set some minimum standards for PI insurance policies. We have observed that it is possible to obtain insurance cover that offers little effective protection for retail client claims due to policy exclusions, insufficient amounts of indemnity and restrictive policy terms and conditions. We think setting some minimum standards will also assist in achieving a balance between the

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competing needs for certainty and flexibility that came across in the submissions.

151. We do not recommend Option 6 (*defer implementation*) because we consider that it would be unsatisfactory to continue current arrangements where some licensees have no PI insurance at all.

152. ASIC will require licensees to disclose in FSGs whether they have PI insurance in place, an alternative arrangement approved by ASIC or an exemption. We also require that licensees disclose to their clients whether their representatives are covered for past work after they cease to work for that licensee as we have identified this as an area of risk for consumers. Otherwise we will not mandate particular disclosure in FSGs.

Implementation and review

153. Our proposed policy will be implemented by publishing a regulatory guide. The regulatory guide will set out our policy on:

- our general approach to the compensation requirements: that we will administer the requirements to maximise their potential to achieve the policy objective;
- what is adequate PI insurance going forward;
- what we will consider to be adequate PI insurance during the implementation period of two years;
- how we will assess applications for alternative arrangements to PI insurance;
- exempt licensees and how we will approve guarantees from an exempt licensee; and
- disclosure in FSGs.

154. ASIC will require applicants for new licences from 1 January 2008 to confirm compliance with the compensation requirements and to answer questions about their insurance cover.

155. ASIC will require licensees to make an application for approval of alternative compensation arrangements accompanied by an expert report (i.e. actuarial report) to assist ASIC to assess whether the arrangements give no less protection than PI insurance, if the application is novel.

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156. ASIC will also have the discretion to discharge security bonds from this time where licensees have PI insurance or alternative arrangements in place.

157. During the implementation period, ASIC will accept PI insurance that complies with our implementation period policy as adequate. We will encourage industry and professional bodies to consider developing standard policies or group schemes for their members during this time.

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