Australian Securities & Investments Commission

REPORT 459

Professional indemnity insurance market for AFS licensees providing financial product advice

December 2015

About this report

This report contains our findings about the state of the professional indemnity (PI) insurance market for Australian financial services (AFS) licensees that provide financial product advice to retail clients on Tier 1 products.

We also analyse where there may be a risk of non-compliance with current law and policy, as well as other regulatory risk such as the potential lack of practical availability of adequate PI insurance.

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- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

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Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

Executive summary

1 All Australian financial services (AFS) licensees who provide financial services to retail clients must have arrangements for compensating those clients. Generally this means holding adequate professional indemnity (PI) insurance unless an exemption applies or a licensee has alternative arrangements approved by ASIC.

2 What amounts to 'adequate' PI insurance depends on each AFS licensee's circumstances—including, for example, the nature of the licensee's business. Our minimum requirements for adequate PI insurance are set out in Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126).

3 Although the regulatory regime requires AFS licensees to hold adequate PI insurance, it is reasonable to assume that most, if not all, businesses would acquire PI insurance regardless of the regulatory requirement. Therefore, the cost of PI insurance should not solely be considered a cost of regulation.

Background

4 Between November 2014 and June 2015, we conducted a review of the PI insurance market for AFS licensees that provide financial product advice to retail clients on Tier 1 products. In this report, we refer to these licensees as 'advice licensees'.

Note: See 'Key terms' for the definition of 'Tier 1 products'.

5 This report sets out the findings of our review as at 30 June 2015.

6 We sought to understand the availability and cost of PI insurance. We wanted to:

(a) test the concerns we have heard over the past few years from some advice licensees that they have been unable to secure PI insurance at a reasonable cost; and

(b) determine whether the insurance that is available conforms with ASIC's guidance about what we consider to be adequate PI insurance—in particular, whether there are any significant deficiencies in the PI insurance that is generally available to advice licensees.

7 More generally, this review was important because we do not have objective data about PI insurance, including the extent to which advice licensees hold adequate PI insurance. In addition to the concerns raised by some advice licensees about the difficulty in securing reasonably priced PI insurance, there are other indicators that advice licensees may not hold adequate PI insurance—in

particular, the high level of unpaid external dispute resolution (EDR) scheme determinations.

> Note: Unpaid determinations do not necessarily mean that an AFS licensee's PI insurance is inadequate. In some situations, a licensee will have unpaid determinations no matter how much PI insurance it holds.

8 For more background information about why we undertook this review, see Section A.

Availability of PI insurance

9 We found that, like most areas of insurance, PI insurance is cyclical with reduced market capacity and significant premium increases in periods where insurers suffer poor profit ratios. There was such a period from late 2008 until 2014, as a result of the global financial crisis (GFC) and a number of significant failures of financial products and advice licensees.

10 As we passed the seven-year anniversary of the GFC, however, market conditions improved. At the time of our inquiries, the market was stable with sufficient market capacity and flattening premiums.

11 On 7 October 2015, one of the insurers that provides PI insurance to advice licensees, Axis Specialty Australia, announced its intention to wind down its retail insurance operations in Australia. We will monitor the impact of this announcement on the capacity of the PI insurance market for advice licensees.

12 In our review, we obtained detailed information from four insurers about the PI insurance they offer to small advice licensees (i.e. those with around 20 authorised representatives or fewer, and revenue of $2 million or less). Based on this information, we understand that:

(a) the minimum premium was around $7,000 (excluding goods and services tax (GST) and stamp duty)—this has increased from about $2,000 in 2009;

(b) around a quarter paid a premium of $10,000 or less (excluding GST and stamp duty);

(c) more than half paid a premium of less than $20,000 (excluding GST and stamp duty); and

(d) the minimum excess was around $10,000.

13 Although market conditions have improved, insurers and insurance brokers report that insurers continue to be far more selective and cautious in offering PI insurance cover than they were before the GFC.

14 As discussed at paragraph 127, automatic run-off cover is still not generally available. Insurers do offer run-off cover to advice licensees intending to close

their businesses (as distinct from automatic run-off cover which is negotiated upfront at the commencement of the PI insurance policy and will apply even if the advice licensee becomes insolvent). However, even this type of run-off cover is not widely taken up by advice licensees.

15 Consequently, advice licensees do not generally have PI insurance cover for claims made after the end of the term of their most recent PI insurance policy. (Policies are usually 12 months.)

16 For further discussion about the availability of PI insurance, see Section D.

Adequacy of PI insurance

17 We identified five areas where there is a gap between our requirements in RG 126 and the PI insurance policies that are generally available. These areas are summarised below.

18 We expect industry to address these issues. We intend to follow up on our concerns about gaps in cover with surveillance of advice licensees.

19 For further discussion about the adequacy of PI insurance, see Section E.

Defence costs

20 We require defence costs to be covered over and above the required minimum limit of indemnity. However, of the 591 small advice licensees for whom we received detailed information from the insurers reviewed, almost 14% held PI insurance policies where defence costs were included in the minimum limit of indemnity (i.e. $2 million).

Reinstatements

21 In RG 126 we state that, as a minimum requirement, insurance policies should include at least one automatic reinstatement. This means that, if the limit of the policy is exhausted before the end of the policy period, the limit of indemnity is reinstated for the balance of the policy period to cover any new claims. Automatic reinstatement is not necessary where the policy limit is at least twice the minimum amount of cover required to be held by the AFS licensee.

22 Generally, the insurers reviewed told us their policies include a reinstatement. One insurer confirmed its standard terms and conditions do not include reinstatements. We do not know exactly how many of the 185 advice licensees covered by that insurer had a reinstatement written back into their individual policy, or whether the policy had a limit of indemnity that was twice the minimum amount required, thereby meeting the reinstatement requirement.

Fraud and dishonesty cover

23 In RG 126, we state that PI insurance policies must not have the effect of excluding fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders).

24 We found the policies of two of the four insurers in our review did not provide the required fraud and dishonesty cover. These two insurers cover 333 advice licensees.

Aggregation of claims—Limit of indemnity

25 In RG 126, we anticipate that PI insurance policies may include a clause aggregating related claims so that they are treated as one claim with a single limit of indemnity. We also anticipate an indemnity sub-limit for claims pursued through an EDR scheme. (Generally, sub-limits reflect the scheme's jurisdictional limit.)

26 Problems arise where PI insurance policies include both an aggregation clause and an EDR scheme sub-limit. This was the case for the policies of three of the four insurers in our review.

27 In these cases—depending on the circumstances, such as the nature of the advice—the insurer may treat a number of different claims (e.g. those of a husband, wife and self-managed superannuation fund (SMSF)) as a single claim, and also apply the sub-limit, giving rise to a potentially significant gap in cover.

28 More generally, this issue reflects a misalignment between how insurers and EDR schemes define a claim. This issue is discussed at paragraphs 156–157.

Lack of claim aggregation—Excess payable

29 Conversely to our concerns about the aggregation of claims, there is also regulatory risk where PI insurance policies do not, or insurers would not (even if they could), aggregate claims. This is because, in these circumstances, a separate excess would be payable by the advice licensee for each claim, so that the total excess payable would be unaffordable for a licensee unless it has significant other financial resources.

Other findings

30 Our priority in the project was to gather information about the state of the PI insurance market for advice licensees, but we also sought to acquire a general understanding of:

(a) whether there appears to be significant concern about the timeliness with which claims proceed; and

(b) any reason that might explain insurers' refusal to provide information to EDR schemes about the PI insurance cover they provide to specific advice licensees.

31 We found the following:

(a) Consistent with public comment and our operational experience, the EDR schemes reported being significantly impeded by their inability to identify which insurer provides PI insurance to an advice licensee, or even whether there is PI insurance that would respond to a claim.

(b) Otherwise, stakeholders with whom we consulted did not report widespread concern about insurers' handling of claims. However, this was generally because they had insufficient experience with making claims to be able to comment.

32 Insurers reported that they may not provide information to EDR schemes, when requested, because:

(a) EDR schemes have no contractual right to the information;

(b) some policies allow insurers to direct policyholders not to disclose details of their insurance to an EDR scheme; and

(c) details of PI insurance cover are irrelevant to an EDR scheme determination, and disclosure can be a strategic disadvantage in settlement negotiations.

33 We acknowledge that there may be legal and/or commercial impediments to the provision of PI insurance details to EDR schemes. However, we think it is important that insurers work effectively with EDR schemes to support, in good faith, the operation of the schemes and payment of determinations. We encourage EDR schemes and the insurance industry to continue to find ways to work towards openly sharing information to the extent possible.

34 For more details on the other findings from our review, see Section F.

Regulatory framework

35 Under s912B of the *Corporations Act 2001* (Corporations Act), AFS licensees must have arrangements for compensating retail clients for losses they suffer as a result of a breach by the licensee or its representatives of their obligations in Ch 7 of the Corporations Act.

Note: References to legislation in this document relate to the Corporations Act, unless otherwise specified.

36 These arrangements must:

(a) satisfy the requirements in the Corporations Regulations 2001 (Corporations Regulations), which are that AFS licensees must obtain PI insurance cover that is adequate, considering the nature of the licensee's business and its potential liability for compensation claims (reg 7.6.02AAA); or

(b) be approved by ASIC as alternative arrangements.

37 The Corporations Regulations also provide exemptions from the requirements for some AFS licensees that are regulated by the Australian Prudential Regulation Authority (APRA) or are related to an entity regulated by APRA: reg 7.06.02AAA(3).

38 In RG 126, we provide guidance about:

(a) the processes we think AFS licensees should go through to determine what is adequate PI insurance for them; and

(b) our minimum requirements for a PI insurance policy so that it provides an adequate amount of cover.

39 The most significant change we have made to RG 126 since it was first published in late 2007 was to remove the requirement for 'automatic run-off' cover. This change took effect in January 2010. It was considered necessary because automatic run-off cover was not practically available to AFS licensees at the time.

40 For more details on the regulatory framework for our review, see Section B.

Scope and methodology

41 Our methodology involved:

(a) a desk-based review of comments by, and consultation with, key stakeholders including the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO), relevant industry associations, insurance brokers and the Insurance Council of Australia. We also considered the information that we received (largely unsolicited) from advice licensees;

(b) the consideration of unpublished information provided to us by APRA from its National Claims and Policies Database collection of PI insurance policy and claims data;

(c) a review of the standard terms and conditions of a number of PI insurance policies issued to advice licensees; and

(d) the analysis of detailed information about 591 advice licensees' PI insurance that we obtained from the four insurers we understood to be the most active in providing cover to small advice licensees—that is, licensees with around 20 authorised representatives or fewer, and revenue of $2 million or less that we judged to be the most vulnerable in the market.

Note 1: In this report, we refer to these four insurers as the 'relevant insurers' and the 591 advice licensees captured by the insurers' data as the 'relevant licensees'.

Note 2: The basis on which we made this selection and what we found when we gathered further information is discussed at paragraphs 87–90.

42 Even with the information we have gathered to date, it is difficult to draw any firm conclusions about the specific extent of any non-compliance with RG 126. To do so would require the review and assessment of a sample of advice licensees' PI insurance arrangements and a detailed understanding of their business and resources, including the total financial resources held by the licensee to pay the excess and cover any gaps. However, we have gathered a good overview of the market and identified areas of key regulatory risk for further consideration.

43 For more details on the scope of our review and what our methodology involved, see Section C.

A Background

Key points

The purpose of this project was to understand the current market for PI insurance for advice licensees. In particular, we sought to understand the availability and cost of PI insurance, and whether that insurance conforms with ASIC's guidance about what we consider to be adequate PI insurance.

Under the Corporations Act, all AFS licensees who provide financial services to retail clients must have arrangements for compensating those clients for losses resulting from a breach of the obligations in Ch 7 by the licensee or its representatives. Generally this means holding adequate PI insurance unless an exemption applies or a licensee has alternative arrangements approved by ASIC.

PI insurance is designed to protect AFS licensees by reducing the risk that a retail client's claims cannot be met by the licensee due to a lack of financial resources. It is not designed to provide compensation directly to clients.

As a compensation mechanism, PI insurance has a number of inherent limitations.

Purpose of our project

44 Between November 2014 and June 2015, we conducted a review of the PI insurance market for advice licensees. The purpose of this project was to understand the current market for PI insurance for advice licensees. In particular, we sought to understand:

(a) the availability and cost of PI insurance; and

(b) the adequacy of that PI insurance—by testing it against our guidance in RG 126 on what is 'adequate' PI insurance cover.

We also wanted to understand the extent to which the availability and cost of PI insurance for advice licensees has changed over recent years.

ASIC data about PI insurance

45 Before granting an AFS licence, we ask licence applicants about their PI insurance arrangements. As set out in Regulatory Guide 2 *AFS Licensing Kit: Part 2—Preparing your AFS licence or variation application* (RG 2) at RG 2.229–RG 2.231, we do not grant an AFS licence until we are satisfied that the applicant has the necessary arrangements in place. However, ASIC does not approve PI insurance arrangements, nor do we have data about the renewal of advice licensees' PI insurance cover.

46 Therefore, we do not have objective data that would enable us to assess:

(a) the availability, adequacy or cost of PI insurance for current AFS licensees; or

(b) the extent to which current AFS licensees comply with the requirement to hold adequate PI insurance.

This reflects the fact that the obligation to assess the adequacy of PI insurance falls primarily on the licensee.

47 Licensees must conduct their own assessment of their PI insurance needs. What would be adequate PI insurance can, in fact, only be determined by each licensee with reference to its membership of an EDR scheme and the maximum liability that may arise, as well as the nature of the licensee's business.

Why undertake this project now?

48 Over the past few years, regular concerns have been raised—reported in the press as well as privately to ASIC—that some advice licensees are unable to get PI insurance cover that meets the standards of adequacy set out in RG 126 or, if they are able to secure PI insurance that is compliant with RG 126, they cannot do so at a reasonable cost. Advice licensees referred to premiums having gone up very significantly, even for firms with clean claims records.

Note: For data that supports this observation about increased premiums, see paragraph 122.

49 In addition to these concerns, there are other indicators that some advice licensees may not hold adequate PI insurance—in particular, the high level of unpaid EDR scheme determinations, predominantly in the financial advice sector.

50 For the period from 1 January 2010 to 30 June 2015, 33 financial services providers failed to comply with 133 FOS determinations made in favour of 188 consumers. As at 30 June 2015, the value of outstanding determinations was $12.6 million plus interest, representing almost 25% of all determinations issued by FOS in its investments, life insurance and superannuation stream. Of these outstanding determinations, 58% relate to disputes in the financial advice sector.

51 Unpaid determinations do not necessarily mean an AFS licensee's PI insurance is inadequate. In some situations, a licensee will have unpaid determinations no matter how much PI insurance it holds. However, inadequate PI insurance may be a factor contributing to the unpaid determinations.

Compensation requirements and the role of PI insurance

52 Under s912B of the Corporations Act, AFS licensees who provide financial services to retail clients must have arrangements for compensating those clients for losses they suffer as a result of a breach of the obligations in Ch 7 by the licensee or its representatives.

53 These arrangements must:

(a) satisfy the requirements in the Corporations Regulations, which are that AFS licensees must obtain PI insurance cover that is adequate, considering the nature of the licensee's business and its potential liability for compensation claims (reg 7.6.02AAA); or

(b) be approved by ASIC as alternative arrangements.

54 The Corporations Regulations also provide exemptions from the requirements for some AFS licensees that are regulated by APRA or are related to an entity regulated by APRA: reg 7.06.02AAA(3).

55 The Government's objective in introducing the requirement for PI insurance was to reduce the risk that retail clients' compensation claims could not be met by the relevant AFS licensee due to a lack of financial resources.[1] Providing compensation directly to consumers was not part of this objective. PI insurance does not, and cannot, ensure that consumers will always receive compensation.

56 In RG 126, we set out how an AFS licensee should determine the level of PI insurance cover that would be adequate.

57 Among other things, adequacy must be determined by reference to the nature of the AFS licensee's business and the licensee's potential liability for successful claims brought through an EDR scheme. We also note that the assessment should be ongoing—undertaken at least annually—and an element of adequacy will be what is practically available at any given time.

58 We recognise in RG 126 that PI insurance will not always cover claims made against an AFS licensee. Licensees must ensure they have sufficient financial resources to pay the excess and cover any gaps.

Key concerns with the current compensation requirements

59 Since the introduction of the financial services reform (FSR) legislation, there has been discussion about the regulatory role PI insurance can and should play in ensuring consumers have access to appropriate compensation.

[1] The Government's objective is set out in the regulation impact statement, *Compensation arrangements for financial services licensees*, April 2007, p. 7.

60 Often, there is a fundamental misalignment between, on the one hand, the product features and business purpose of PI insurance and, on the other hand, the broader public policy objective of the compensation arrangements, as set out at paragraph 54.

61 ASIC has publicly[2] referred to the inherent limitations of PI insurance as a compensation mechanism. Most significantly, we note the following:

(a) We do not 'approve' PI insurance arrangements and AFS licensees do not have a positive obligation to provide evidence of annual or other periodic renewal of PI insurance.

(b) PI insurance is a commercial product—insurers who provide cover do so on a commercial basis. Therefore, availability, cost and terms and conditions vary—sometimes significantly—between insurers and at different times.[3]

(c) While ASIC provides detailed guidance to AFS licensees, we cannot regulate for a market-driven product. We cannot require insurers to extend or limit cover, nor can we prescribe key product features or policy terms, or influence price or the operation of exclusions and excesses.

(d) PI insurance is designed to protect AFS licensees against business risk. It is neither intended nor designed to provide compensation directly to consumers. Therefore, even if a consumer is successful in their claim made to an EDR scheme, it is the AFS licensee that must make a claim on its PI insurance to compensate the consumer as required. The consumer cannot claim directly on the PI insurance.

(e) PI insurance is held by the AFS licensee—therefore:

(i) the licensee must determine the adequacy of cover, continue to pay for cover and take steps to ensure payment from the insurer if a claim arises (e.g. by giving timely notifications); and

(ii) the insurer may avoid liability under a policy because of the licensee's conduct (e.g. failure to disclose matters on entering into the policy).

(f) PI insurance policies are offered on the basis that any claim must be made, or at least notified, during the period of cover—typically, 12 months. However, most PI insurance claims are 'long tail'—that is, the claim may not arise until years after the misconduct.[4] If an AFS licensee still holds PI insurance cover at the time a claim arises, the

[2] For example, in our second submission to the 2014 Financial System Inquiry, dated August 2014. (This is discussed further at paragraph 82.)

[3] The report, *An updated proposal to establish a financial services compensation scheme*, published by FOS in May 2015 states at paragraph 2.1.4, that, 'Even with strict guidance from ASIC, it is up to the PI market to determine whether it will offer run-off, how it will impose limits to aggregate claims, excess levels, what types of fidelity it will cover'.

[4] The Richard St John report, *Compensation arrangements for consumers of financial services* (discussed in detail at paragraphs 72–79), notes that, according to APRA, for PI insurance: '…the majority of payments being made are in respect of claims from accident years of between two and seven years before the current year'.

current PI insurance policy may respond to the claim, assuming the claim could not have been notified earlier. However, if an AFS licensee no longer holds current PI insurance—such as where the licensee has ceased to operate or has gone into external administration—the consumer may not receive compensation.

(g) For complex or multiple claims, the funds available under a PI insurance policy may be insufficient to cover all claims. In some cases, this arises due to a common policy term that aggregates related claims (see paragraph 145 for further discussion on claims aggregation).

62 The limitations of PI insurance as a compensation mechanism are exacerbated because, rather than properly assessing gaps in cover and ensuring they hold sufficient financial resources to cover those gaps as well as the excess (as required by RG 126), some AFS licensees appear to rely on PI insurance alone.[5]

[5] This is our understanding based on anecdotal evidence we gathered from our discussions with AFS licensees, industry associations and insurance brokers. We consider this is also consistent with the current high levels of unpaid EDR scheme determinations.

B Regulatory framework

Key points

AFS licensees that provide financial services to retail clients must have arrangements for compensating those clients for losses resulting from a breach of the obligations in Ch 7 by the licensee or its representatives. Generally this means holding adequate PI insurance unless an exemption applies or a licensee has alternative arrangements approved by ASIC.

Adequacy must be determined by each licensee with reference to its membership of an EDR scheme and the maximum liability that may arise, as well as the nature of the licensee's business.

In RG 126, we provide guidance about the processes we think AFS licensees should go through to determine what is adequate PI insurance for them, and our minimum requirements for the common features of a PI insurance policy.

Since the introduction of the FSR legislation, this regulatory framework has been reviewed. Each of the key reviews—the 2012 Richard St John report and the 2014 Financial System Inquiry—identified significant limitations on the extent to which PI insurance cover is able to meet consumers' claims.

Current law

63 Under s912B, if an AFS licensee provides financial services to retail clients, the licensee must have arrangements for compensating those clients for loss or damage suffered because of a breach of the relevant obligations in Ch 7 by the licensee or its representatives. The arrangements must:

(a) satisfy the requirements in the Corporations Regulations (see paragraph 65); or

(b) be approved by ASIC as alternative arrangements.

64 The Corporations Regulations also provide exemptions from the PI requirements for some AFS licensees that are regulated by APRA or are related to an entity regulated by APRA: reg 7.06.02AAA(3).

65 Under reg 7.6.02AAA, AFS licensees must hold PI insurance cover that is adequate, taking into account:

(a) the licensee's membership of an EDR scheme and the maximum liability that has, realistically, some potential to arise in connection with:

(i) any particular claim against the licensee; and

(ii) all claims for which the licensee could be found to have liability; and

(b) relevant considerations in relation to the financial services business carried on by the licensee, including:

(i) the volume of business;

(ii) the number and kind of clients;

(iii) the kind or kinds of business; and

(iv) the number of representatives of the licensee.

Current ASIC policy

66 In RG 126, we provide guidance about the processes we think AFS licensees should go through to determine what is adequate PI insurance for them, and the features a PI insurance policy should have for it to be considered adequate.

67 At RG 126.24–RG 126.40, we set out the key principles that guide our administration of the compensation requirements, as summarised below:

(a) principle 1—'adequate' means the compensation arrangements are fit for achieving the policy objective (which is to reduce the risk that a retail client's losses due to breaches of Ch 7 for which an AFS licensee is responsible cannot be compensated by a licensee because of a lack of financial resources);

(b) principle 2—it is the basic responsibility of licensees to undertake their own analysis of what is adequate for them, considering their individual business and risks; and

(c) principle 3—an element of adequacy is what is practically available at any given time.

68 In RG 126, we state that whether a PI insurance policy is adequate depends on several factors:

(a) the amount of cover—to be adequate, the limit of indemnity under the policy should cover a reasonable estimate of the potential losses by retail clients (RG 126.43);

(b) the scope of cover—the PI insurance must cover losses or damage caused by negligent, fraudulent or dishonest conduct that amounts to a breach of Ch 7 and gives rise to liability to retail clients (RG 126.44);

(c) whether the terms and conditions of the cover undermine the overall effect of the policy—for example, by excluding cover for key aspects of the AFS licensee's business (RG 126.45); and

(d) whether the AFS licensee has sufficient financial resources to enable the PI insurance policy to work in practice—for example, licensees must ensure they have sufficient financial resources to pay the excess and cover any gaps due to exclusions in the policy (RG 126.48).

69 In Table 4 of RG 126, we set out our view of the minimum requirements for the common features of a PI insurance policy so that the policy cover is adequate. These features include, for example, the amount of cover, the scope of cover and exclusions. (Compliance with the requirements in Table 4, where relevant, is discussed in detail in Section E below.)

70 The current version of RG 126 was published in December 2010. There were three previous versions:

(a) in November 2007, RG 126 was first published;

(b) in March 2008, various minor amendments were made to clarify licensees' PI insurance obligations—most notably:

   (i) the scope of cover required in respect of fraudulent and dishonest acts was clarified to be liability for fraud and dishonesty by directors, employees and other representatives of the licensee—replacing the previous reference to the policy covering 'fraud by the licensee (except sole practitioners) and representatives';

   (ii) automatic reinstatement would not be required where the PI insurance policy's limit of indemnity is at least twice the required minimum amount of cover; and

   (iii) a note was added to Table 4 to the effect that a PI insurance policy would not be inadequate merely because it contains a lower sub-limit for EDR scheme awards (EDR scheme sub-limit); and

(c) in October 2009 (with effect from January 2010), the requirement for AFS licensees to obtain 12 months automatic run-off cover was removed because it was not practically available in the market.

Review of the regulatory framework

71 Since the introduction of the FSR legislation, the regulatory framework for current compensation arrangements has been reviewed. The key Government reviews are discussed below.

Richard St John report (April 2012)

72 Richard St John was commissioned by the Government to review the current compensation arrangements, including the requirement for AFS licensees to hold adequate PI insurance.

73 In his findings, Mr St John accepted that PI insurance is an imperfect mechanism to compensate retail clients who suffer loss as a result of an AFS licensee's misconduct. He identified significant limitations on the extent to which PI insurance cover is able to meet claims, including where:

(a) a licensee is in breach of its contractual obligations under the policy;

(b) a claim falls within an exclusion in the policy;

(c) a claim is less than the policy excess;

(d) a claim exceeds the policy limit (or sub-limit); or

(e) a claim is made after the cancellation of an insolvent licensee's policy.

74 The St John report[6] also found other problems with the available PI insurance, including that:

(a) even though liabilities associated with providing financial services are generally 'long tail', PI insurance operates on a 'claims made' basis;

(b) not all PI insurance policies meet ASIC's requirements set out in RG 126 (i.e. Table 4)—for example, in respect of fraud or dishonesty cover (fraud cover is considered further at paragraph 142); and

(c) there is limited availability of run-off insurance cover (this issue is discussed at paragraph 124).

Report recommendations

75 Although he accepted that the current compensation arrangements have shortcomings, Mr St John did not support the introduction of a statutory last-resort compensation scheme. He noted the burden such a scheme would place on responsible and financially secure AFS licensees to underwrite claims against weaker licensees.

76 Instead, Mr St John made a number of recommendations aimed at improving the current arrangements and suggested that a statutory compensation safety net could be revisited once the regulatory platform had been made more 'robust and stable'.

77 Mr St John's recommendations included:

(a) tightening the existing PI insurance requirements—for example, by:

(i) requiring AFS licensees to provide ASIC with additional assurances about the adequacy of their PI insurance;

(ii) ASIC taking a more proactive approach in monitoring AFS licensee compliance with the requirement to hold PI insurance; and

(iii) ASIC giving further consideration to the treatment of defence costs in its approach to the adequacy of PI insurance;

(b) giving more attention to the adequacy of AFS licensees' financial resources and ASIC being prepared to take action to enforce its published views of what is required by the licensing conditions on financial resource requirements; and

(c) strengthening ASIC's powers to sanction AFS licensees that do not comply.

[6] Richard St John, *Compensation arrangements for consumers of financial services*, final report, April 2012.

ASIC's response

78 We consider that no amount of tightening the existing PI insurance requirements would be sufficient to deal with the issue of uncompensated loss. From our discussions with insurers in the past, it is clear that they would not be willing to write cover that indemnified advice licensees for all liability to retail clients.

79 In addition, we note that increasing capital adequacy requirements to the extent needed to cover all retail client losses may place an unreasonable burden on advice licensees, especially small advice licensees.

Financial System Inquiry reports (July and November 2014)

80 The 2014 Financial System Inquiry's interim report, dated July 2014, recognised the limitations of PI insurance as a mechanism for compensating consumer loss and raised it as an issue for further consideration.

81 In its final report, dated November 2014, however, the inquiry did not make any recommendations about the current consumer compensation arrangements.

82 ASIC's second submission to the Financial System Inquiry, dated August 2014,[7] confirmed our support for a limited statutory last-resort compensation scheme to supplement the PI insurance requirements and the formal determination of claims by EDR schemes. We indicated that such a scheme would address the relatively high levels of uncompensated loss in the financial advice sector and minimise the risk of erosion of consumer confidence and trust in financial services. We note that the Government's response to the Financial System Inquiry did not support such a scheme.

[7] At paragraphs 22–23 and 183–198.

C Scope and methodology

Key points

The methodology for our review involved:

- a desk-based review of comments by, and consultation with, key stakeholders in the industry;
- the consideration of unpublished information provided to us by APRA;
- a review of the standard terms and conditions of PI insurance policies offered by six insurers to advice licensees; and
- the analysis of detailed information about 591 advice licensees' PI insurance that we received from the four insurers we judged to be the most active in providing PI insurance cover to small advice licensees.

As a result of this work, we have obtained a good overview of the PI insurance market, including identifying areas of key regulatory risk for further consideration.

However, we are not able to draw firm conclusions about the specific extent of non-compliance with RG 126 using the information gathered. To do so would require significant resources and time, entailing a detailed assessment of each advice licensee's individual circumstances.

83 In setting the scope of this review, we balanced our aim of gaining a reliable understanding of the PI insurance market for advice licensees with the resources available to us and the desire to achieve our goal in a reasonable timeframe.

84 We limited our review to consultation with key stakeholders, as well as data collection from APRA and the four insurers that we understood to be the most active providers of PI insurance cover to small advice licensees. As discussed at paragraphs 86(d) and 96, we also obtained detailed data about a significant number of advice licensees' PI insurance from these four insurers.

85 We did not analyse individual advice licensees' PI insurance policies but we did review the standard policy terms and conditions issued by six insurers to advice licensees.

General methodology

86 Our methodology involved:

(a) a desk-based review of comments by, and consultation with, key stakeholders—including FOS, CIO, relevant industry associations, insurance brokers and the Insurance Council of Australia—about their recent experiences of the market. We also considered the information that we received (largely unsolicited) from advice licensees;

(b) the consideration of unpublished information provided to us by APRA from its National Claims and Policies Database (NCPD) collection of PI insurance policy and claims data;

(c) a review of the standard terms and conditions of PI insurance policies offered by six insurers to advice licensees, comparing the terms against RG 126 (in particular, Table 4) and also comparing policies against each other; and

(d) the analysis of detailed information about 591 advice licensees' PI insurance that we obtained from the four insurers we understood to be the most active at the smaller, more vulnerable end of the financial advice market. (The basis on which we made this selection, and the extent to which we covered the market, is discussed in the following paragraphs.) The information we sought from these four insurers was aimed at testing and obtaining further details about our findings to that point.

Basis of our findings

Determining the market segment representing the most regulatory risk

87 Initially, we sought to gather information about the PI insurance market for all advice licensees. However, as we began gathering information—including from our discussions with insurance brokers specialising in PI insurance for advice licensees and the PI insurance committee of the Insurance Council of Australia—the consensus was that larger advice licensees do not appear to have significant issues with securing PI insurance. They also self-insure to some degree.

88 This finding was consistent with our general experience, as well as with the concerns raised by small advice licensees about the state of the PI insurance market referred to at paragraph 48.

89 We formed the view that small advice licensees (i.e. those with around 20 authorised representatives or fewer, and revenue of $2 million or less) presented the highest level of regulatory risk in terms of failing to hold adequate PI insurance, and would be the most vulnerable in the PI insurance market.

90 It is worth noting that, subsequently, we have heard from one insurer that its preference is to provide PI insurance to the smallest firms—that is, those in which the principal works with just a few additional staff. This insurer is more concerned by medium-sized firms with, say, between 10 and 40 representatives. The insurer considers that such firms may represent more risk than the smallest firms, which generally have a hands-on principal who exercises control in terms of compliance and day-to-day activities.

Gathering information about the relevant market segment

91 Given our view that small advice licensees present the most regulatory risk, we focused our more detailed research accordingly. Specifically, we sought to identify which insurers were the most active in covering small advice licensees and requested more detailed information from those insurers.

92 There is no single source of information available about which insurer provides PI insurance cover to each advice licensee.

93 As noted at paragraph 45, we do not hold information about the PI insurance arrangements for AFS licensees beyond the licensee's insurer at the time it first acquires its licence. While there is information available from sources outside ASIC, this mostly records data about larger licensees and, even then, is often incomplete. For example, the Money Management Top 100 Dealer Groups Survey data for 2014 includes provision for setting out each dealer group's PI insurance provider. However, especially for the smaller dealer groups, the PI insurer is often not provided. Of the 24 dealer groups with less than 30 'financial planners', only six provided the names of their insurer.[8]

94 Our understanding from speaking with insurers is that even they are unaware of how active they are in the market relative to other insurers.

95 Consequently, our assessment of which insurers provided the most PI insurance cover to small advice licensees was based largely on our discussions with insurance brokers, insurers and relevant industry associations.

96 We identified four insurers as being the most active in covering small advice licensees. We gathered detailed information from these insurers.[9] Based on the responses we received to requests for information from each of these four insurers, we know that, as at 31 March 2015, they provided PI insurance cover to 591 advice licensees—that is, about a quarter of all advice licensees.

Note: In this report, we refer to these four insurers as the 'relevant insurers' and the 591 advice licensees captured by the insurers' data as the 'relevant licensees'.

Other constraints on our information gathering

97 In setting the scope of our review, we considered gathering information about the conduct of PI insurers when claims are made (e.g. the timeliness with which claims proceed) and insurers' interaction with EDR schemes.

[8] These were AIA Australia, AIG Australia Limited, Axis Specialty Australia, Chartis Australia, InterRISK Australia and Vero Insurance.

[9] At the request of one insurer, our request for information was made by way of a formal information-gathering notice.

98 We were constrained by limited resources and this was not a primary focus of our review. However, the information we gathered on these issues is discussed in Section F below.

Opportunity for further work

99 Even with the information we have identified to date, it is difficult to draw firm conclusions about the specific extent of any non-compliance with RG 126. To do so—even for a sample of the relevant licensees—would require the review and analysis of each licensee's PI insurance arrangements and the nature of its business, including the total financial resources held by the licensee. This is because:

(a) what is an adequate level of PI insurance depends on each licensee's circumstances—including, for example, the nature of the licensee's business such as the volume of business, the number and kind of clients, and the number of representatives (see paragraphs 2, 47 and 57); and

(b) we recognise, in RG 126, that PI insurance will not always cover claims made against a licensee and licensees must ensure they have financial resources to cover any gap or excess payable (see paragraphs 58 and 68(d)).

100 We have, however, ensured that our review has been sufficiently detailed for us to identify the areas presenting the highest regulatory risk—that is, the gaps between our requirements for PI insurance cover (as set out in Table 4 of RG 126) and the standard terms and conditions offered to advice licensees.

D Availability of PI insurance

Key points

The availability of PI insurance is cyclical. From late 2008 until 2014, there was a period of reduced market capacity and significant premium increases.

Market conditions have since improved. At the time of our inquiries, we found that the market was stable with sufficient market capacity and flattening premiums.

Although market conditions had improved, insurers continued to be selective and cautious.

The minimum premium for small advice licensees was around $7,000. About a quarter of the relevant licensees paid a premium of $10,000 or less, while more than half paid a premium of less than $20,000. The minimum excess for the same group was around $10,000, although we understand some advice licensees may pay a significantly higher amount.

Automatic run-off cover was still not generally available.

101 As set out in Section A, we sought to understand the availability and cost of PI insurance for advice licensees—that is, we sought to test whether PI insurance is generally available, including at a reasonable price, to advice licensees who seek it.

102 We also sought to understand the direction of the PI insurance market for advice licensees.

103 Generally we found that:

(a) the view of insurers, insurance brokers and advice licensees is that the guidance in RG 126, including our stated requirements about what is adequate PI insurance, balances the need for consumer protection with what is generally available; and

(b) there is a consensus that relying on PI insurance alone will not ensure that retail clients' compensation claims can be met by an advice licensee.[10]

104 We set out below our detailed findings as at 30 June 2015.

Market capacity and direction

105 Like most areas (or lines) of insurance, the availability of PI insurance is cyclical, with reduced market capacity and significant premium increases in periods where insurers suffer poor profit ratios. Poor profit ratios are generally

[10] As noted at footnote 1, the Government's objective is set out in a regulation impact statement published in April 2007.

caused by an increase in successful claims and therefore tend to be in periods of economic downturn or following significant financial product collapse.

From 2004 to 2007–08

106 There is a general consensus in the industry that, from around 2004 to 2007–08, the PI insurance market enjoyed ample market capacity, plenty of competition among insurers, lower premiums and broader coverage.

From late 2008 to 2014

107 As insurers felt the effects of the GFC—and possibly the Westpoint collapse before that—the PI insurance market tightened significantly, not only for advice licensees but for all AFS licensees. The market contracted from around 35 PI insurance providers in 2006 to 10 or less now.[11] With that contraction came less competition, significant premium increases and stricter underwriting criteria.

108 According to general insurance statistics (i.e. data that covers all categories of insurance other than life insurance) released by APRA, the PI insurance class for the 2011–12 financial year operated at a net loss ratio of 55.3%,[12] which is a profitable level. However, anecdotally, there is speculation that insurers suffered far worse loss ratios—of 150% or more—in relation to advice licensees.[13]

109 The worse financial conditions in this period, and possibly also the increased volume of claims going through FOS and the ripple effect of a number of significant collapses of advice licensees, resulted in significantly higher premiums.[14]

Market at 30 June 2015

110 As we passed the seven-year anniversary of the GFC, market conditions were mixed.

111 Most of the insurers and insurance brokers we spoke with described the market as stable with sufficient market capacity. However, they noted that

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[11] ASIC's Report 107, *Compensation arrangements for financial services licensees—Research into the professional indemnity insurance market* (REP 107), published in December 2006, estimated that there were 35 PI insurance providers in the market based on consultation with the chief executive officers of a selection of licensed insurers, the National Insurance Brokers Association and the representative in Australia of Lloyd's of London. By contrast, as at 30 June 2015, we understand there were four core insurers offering PI insurance to small advice licensees, with a further few offering cover quite selectively to certain segments of the market.
[12] APRA's *Quarterly general insurance performance statistics*, September 2002 to the current quarter, Table 10.
[13] Michael Gottlieb of Mega Capital in the *IFA Magazine* article, 'Stormy Skies', 28 May 2013.
[14] This statement is based on widespread anecdotal reports. In the *Australian Financial Review* article, 'Of premium concern: the slow road to PI claims' (7 June 2013), Michael Gottlieb referred to the minimum annual premium for a small independent advisory firm having climbed from between $3,000 and $3,500 'a few years ago' to between $8,000 and $10,000 in 2013.

insurers—learning from recent experience in the market—are far more selective than they were before the economic downturn and remain very cautious, frequently tightening controls on the cover they are willing to provide to advice licensees.

112 One insurer told us, for example, that:

(a) it agrees to provide PI insurance only to about 10% of the advice licensees that apply for cover—the balance are rejected as representing too much risk; and

(b) after reviewing an advice licensee's submission (usually made through an insurance broker), and before determining whether to offer PI insurance cover, the insurer always meets with the licensee. At the meeting, the insurer discusses with the licensee issues such as the licensee's compliance culture. The insurer also often challenges the validity of recommendations made by the licensee reflected in its sample Statements of Advice provided to the insurer in its submission.

113 This is consistent with industry comment. For example, in an article published in the *Australian Financial Review* on 7 June 2013, 'Of premium concern: the slow road to PI claims', one insurance broker[15] was quoted as referring to PI insurance as having become:

> … a game of two halves. The PI insurance market for financial advisory firms has splintered into two distinct groups: incumbent insurers, carrying losses on claims incurred since the global recession that are being forced to up premiums and limit new cover, and unencumbered insurers who can cherry-pick low-risk advisory businesses without the need to overly inflate premiums.

114 Small advice licensees continue to raise concerns—particularly about the cost of the PI insurance available to them and the process they need to go through to get cover. (A key complaint about the process is that they often do not receive offers of PI insurance cover until days before their previous cover expires even if they start the application process months earlier.)

115 The complaints, however, do appear to have dissipated to some extent in 2015.

116 As a result of our research and analysis set out in Section C above, our understanding of the market as at 30 June 2015 is as follows:

(a) Although there were fewer insurers willing to insure advice licensees than there were between 2004 and 2007–08, there were enough active insurers in the market to ensure PI insurance cover was available to all advice licensees. In recent years, as some insurers (e.g. Vero Insurance and Dual Australia Pty Ltd) have withdrawn from the market, others have taken their place.

[15] Michael Gottlieb of Mega Capital.

Note 1: We were told by one insurer that, even if an advice licensee is distressed and unable to secure cover from an Australian insurer, it may be able to get cover, albeit at a higher price, from the London market through Lloyd's of London.

Note 2: As noted at paragraph 11, on 7 October 2015, Axis announced its intention to wind down its retail insurance operations in Australia.

(b) Insurers' risk profiles (i.e. what insurers look for when assessing the risk associated with an advice licensee) varied. Generally, there was limited interest in licensees who:

(i) had made claims (particularly if these were frequent and/or reasonably significant claims);

(ii) were distressed;

(iii) appeared to lack rigour in their processes and the products they recommend; and/or

(iv) offered products that do not match the risk profile of the insurer.

(c) Insurance brokers would be happy to secure two or three reasonable offers of cover for a client licensee, whereas before 2008 they might have expected significantly more offers.

(d) Premiums were flattening and there was no indication the market would see further significant premium increases.

(e) The market was stable, with individual insurers having taken action aimed at insulating themselves from significant loss.

117 While not stated as directly, it appears that advice licensees have been raising their compliance standards as they seek to make themselves a more attractive risk proposition for insurers. (As discussed at paragraph 112(b), some insurers closely review a licensee's documentation, such as compliance manuals and sample Statements of Advice, before deciding whether to offer PI insurance.) Conversely, some licensees were concerned that insurers wield too much power, causing licensees to restrict their approved product lists to stay within the terms of the PI insurance cover.

118 Generally we found that the PI insurance available to advice licensees did cost significantly more than before the GFC.

119 The minimum excess insurers would accept had also increased. We found, however, that PI insurance was still largely affordable, particularly for firms that have been able to maintain compliance standards so they remain a reasonable risk proposition for insurers.

120 In support of this view, we did not hear of any advice licensee forced to withdraw from the market due to inability to afford PI insurance, although we did hear, anecdotally, of a few licensees who had joined larger AFS licensee groups to give them easier (and possibly more affordable) access to PI insurance cover.

121 It is also worth noting that the cost of PI insurance should not solely be considered a cost of regulation. It is reasonable to believe that responsible, active businesses would acquire PI insurance regardless of the regulatory requirement to do so.

Premiums and excesses

122 From our review, we found the following:

(a) The minimum premium an advice licensee could expect to pay was around $7,000 (excluding GST and stamp duty). This level of premium would be for the minimum amount of cover that RG 126 indicates is required for a PI insurance policy to be adequate—that is, a limit of indemnity of $2 million. It is also likely that this would be available to very few advice licensees—possibly only the smallest licensees where the principal works in the firm with up to one or two others, and where the firm's experience, claims history and nature of advice represent very low risk.

(b) We have only limited information about premium levels in past years. However, by way of example, we have set out below a sample of two insurers' past minimum premiums:

Insurers	30 June 2008	30 June 2009	31 March 2015
Insurer A	$4,130	$3,000	$7,100
Insurer B	$2,300	$1,800	$7,700

(c) The average premium for a small advice licensee was likely to be significantly higher than the minimum premium. Based on the information we received from the relevant insurers (which varied in the level of detail provided), we understand that:

(i) around 24% of the relevant licensees paid a premium of $10,000 or less (excluding GST and stamp duty); and

(ii) around 38% of the relevant licensees paid a premium of between $10,000 and $20,000 (excluding GST and stamp duty).

(d) The minimum excess was around $10,000. This had increased, following a push led by underwriters, from a minimum excess of around $5,000–$8,000 as recently as 2013–14.

(e) Most of the relevant licensees had an excess of less than $20,000.

Note: Anecdotally, we heard that a few advice licensees may be subject to excesses as high as $150,000. However, it seems that this would be an extreme case—where the advice licensee presents significant risk.

123 These findings are consistent with the information we received from insurance brokers, who told us that:

(a) they would generally expect an advice licensee to pay a premium of around 1% to 4–5% of revenue depending on cover and claims history. Licensees whose experience in terms of products recommended and loss history is fairly standard (i.e. 'vanilla risk' licensees) would pay a premium of 2–2.5% of revenue; and

(b) until recently, the minimum excess for advice licensees was around $5,000–$8,000. However, following a push by underwriters for higher excesses, the minimum excess had increased and was more likely to be $10,000–$15,000.

Run-off cover

124 As discussed at paragraph 70(c), RG 126 initially required AFS licensees to have 12 months automatic run-off cover for claims that are made after the PI insurance policy has ended.

125 Automatic run-off cover is cover for claims made after the insurance policy has ended which have arisen from the acts or omissions of the insured during the period of insurance cover. The cover is negotiated upfront at the commencement of the PI insurance policy, rather than separately. Automatic run-off cover is distinct from the run-off cover sometimes provided by insurers to advice licensees intending to close their businesses (i.e. businesses in run-off).

126 Consistent with the policy settings in RG 126, in determining what is adequate insurance, we will take into account what is available in the market. We decided to remove the requirement to obtain automatic run-off cover, from January 2010, because it was not available to AFS licensees at the time. We stated that we would continue to monitor the availability of automatic run-off cover and may reassess our position should the market soften and automatic run-off cover become available.

127 We understand automatic run-off cover is still not generally available. By contrast, insurers are willing to provide run-off cover to a business in run-off. This is usually provided for periods of between one and seven years at a cost of about 2.5 to four times the base premium. Generally, terms and conditions remain the same as under the original policy. Even though this type of run-off cover is generally available, it is not widely taken up by advice licensees. Anecdotally, we understand that this is because advice licensees consider it to be prohibitively expensive.

E Adequacy of PI insurance

Key points

We sought to understand whether the PI insurance that is generally available meets our requirements in RG 126.

We identified the following five areas where there appears to be a gap between our requirements and the PI insurance policies that are generally available:

- defence costs—where these are not covered over and above the required minimum limit of indemnity;
- reinstatements—failure to meet the minimum requirement for at least one automatic reinstatement;
- fraud and dishonesty cover—failure to meet the minimum requirement of cover for fraud and dishonesty by directors, employees and other representatives;
- aggregation of claims—potentially significant gaps in cover where policies aggregate related claims and also apply an EDR scheme sub-limit of indemnity to those related claims; and
- lack of claim aggregation—a potential lack of affordability of the total excess payable where claims are not aggregated.

We expect industry to address these issues, and we intend to follow up on our concerns about gaps in cover with the surveillance of advice licensees.

128 As set out in Section A, in addition to finding out about the availability and cost of PI insurance, we sought to understand whether the PI insurance that is available to advice licensees meets the requirements we set out in RG 126.

129 Insurance brokers specialising in the smaller end of the financial advice market told us they try to educate their clients that the terms and conditions of PI insurance policies vary between insurers—especially during periods of sustained premium increases when it is often difficult to convince advice licensees to buy a more expensive policy even if the broker’s view is that it offers better cover.

Our concerns

130 We reviewed the standard terms and conditions of PI insurance policies offered by six insurers to advice licensees. We also tested our understanding of the policies, to a more limited extent, with the relevant insurers. As a result of our review, we identified the following five areas where there is a gap between our requirements in RG 126 and the PI insurance policies that are generally available.

Defence costs

131 In Table 4 of RG 126, we state that, at a minimum, a PI insurance policy should provide for defence costs in addition to the minimum limit of indemnity, or the level of cover should be sufficiently increased to take into account these costs.

132 As specified in Table 4, the minimum limit of indemnity should be:

(a) for AFS licensees with total revenue from financial services provided to retail clients of $2 million or less—at least $2 million per claim and in the aggregate; and

(b) for other larger AFS licensees—equal to actual or expected revenue up to $20 million.

133 We sought to determine whether there is a potential concern among advice licensees with revenue of $2 million or less. To do this, we asked the relevant insurers how many of their active policies:

(a) had the minimum limit of indemnity (i.e. $2 million); and

(b) included defence costs in that limit of indemnity.

134 We found that, at least 82 (or almost 14%) of the 591 relevant licensees appeared to have PI insurance policies where defence costs were included in the minimum limit of indemnity.

135 In addition to failing to meet our requirements, this creates the risk that the indemnity offered by a PI insurance policy will be used to cover defence costs rather than being available to claimants.

Richard St John's discussion of defence costs

136 As discussed at paragraph 76, the St John report made a number of recommendations aimed at improving the current compensation arrangements for AFS licensees, including the proposal that ASIC should give further consideration to the treatment of defence costs.

137 Notably, Mr St John's concern was that the requirement regarding defence costs set out in RG 126 was too low.[16] Our findings suggest that some AFS licensees are failing to meet even that requirement.

Reinstatements

138 In Table 4 of RG 126, we state that it is a minimum requirement for PI insurance policies to include at least one automatic reinstatement. This means that, if the limit of the policy is exhausted before the end of the policy period,

[16] Mr St John suggested that consideration should be given to requiring that PI insurance policies set an internal limit on the proportion or dollar value of the policy that can be used for defence costs.

the limit of indemnity is reinstated for the balance of the policy period to cover any new claims that may arise. However, automatic reinstatement is not necessary where the policy's limit of indemnity is at least twice the minimum amount of cover required to be held by the AFS licensee.

139 To test whether this requirement is being met, we reviewed the standard terms and conditions of the PI insurance policies offered by six insurers (including the four relevant insurers). We also asked the relevant insurers how many of their active policies include one or more automatic reinstatements.

140 Some of the insurers told us that all of their active PI insurance policies comply with the reinstatement requirement in Table 4. Another insurer advised that this was also the case for about 97% of its portfolio of relevant licensees' PI insurance.

141 One insurer told us, however, that the standard terms and conditions of the PI insurance cover it offers to advice licensees do not include a reinstatement of the limit of liability. As at 31 March 2015, that insurer covered 185 relevant licensees. We do not know exactly how many of these licensees had a reinstatement written back into their individual policy, or whether the policy had a limit of indemnity that was twice the minimum amount required—either of which would mean the licensee met the reinstatement requirement.[17]

Fraud and dishonesty cover

142 In Table 4 of RG 126, we state that PI insurance policies must not have the effect of excluding fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders).

143 To test whether this requirement is being met, we reviewed the standard terms and conditions of the PI insurance policies held by the relevant licensees. We also asked the insurers how many of their active policies indemnify a licensee in respect of fraud, dishonesty or infidelity by directors, employees and other representatives of the licensee.

144 Based on our review of the policy terms and the insurers' responses, we believe only two of the four relevant insurers comply with RG 126 in relation to fraud and dishonesty.

Aggregation of claims—Limit of indemnity

What is a claims aggregation clause?

145 Aggregation clauses provide that, for the purposes of the policy, interrelated claims will be treated as a single claim and therefore subject to a single limit of indemnity.

[17] We do know that 36 of the 185 relevant licensees covered by this relevant insurer have only the minimum limit of indemnity (i.e. $2 million). However, it may be that some of these licensees have a reinstatement clause written into their individual policies.

146 The terminology varies between policies but, in some policies, claims are considered to be interrelated when they relate to the same 'event', which may be defined as the failure of a financial product. Therefore, a potentially large number of pieces of advice, each provided to different clients, could be aggregated and subject to a single limit of indemnity.

147 In other cases, for the aggregation clause to apply, the claims must arise out of, or be based on or attributable to the same facts or circumstances or the same act, error, omission or other conduct. For example, if a husband, wife and SMSF each invest based on a single piece of poor advice, and that advice results in losses to each of those parties, their multiple claims may be treated as a single claim by the insurer. Consequently, they will be subject to a single limit of indemnity.

Aggregation clauses and EDR scheme sub-limits

148 The example in paragraph 147 (i.e. where multiple claims may be subject to a single limit of indemnity) is not necessarily a problem in itself. Indeed, RG 126 anticipates the use of aggregation clauses. Table 4 notes they are a factor to consider in terms of a policy's adequacy. We state that AFS licensees will be effectively self-insuring to cover claims outside the aggregated limits.

149 The more significant problem, in our view, is when a PI insurance policy includes both an aggregation clause and another common clause known as an EDR scheme sub-limit. Under an EDR scheme sub-limit, the maximum amount of cover the insurer will pay for a claim that is made through an EDR scheme (rather than, for example, a court order) is significantly less than the policy's full limit of indemnity (of $2 million or more[18]). For example, one insurer's PI insurance policy provides for a limit of indemnity for a claim made through an EDR scheme of up to $150,000 for most awards.

150 As with aggregation clauses, Table 4 of RG 126 anticipates the use of EDR scheme sub-limits. We state that a policy will not be inadequate merely because it contains a lower sub-limit on the amount that can be claimed as a result of an EDR scheme award. However, applying the aggregation clause as well as the sub-limit to the example in paragraph 147:

(a) the insurer may treat their various claims as a single claim (according to the claims aggregation clause); and

(b) if the claims are made through an EDR scheme (rather than a court), the insurer may also apply the lower EDR scheme sub-limit.

This means that all the claims together would be paid, for example, a maximum of $150,000.

[18] Table 4 of RG 126 (at 'Amount of cover') provides for a limit of indemnity of at least $2 million.

151 The potential shortfall in cover could be even more severe if the PI insurance policy aggregates claims related to a single 'event' (e.g. the failure of a financial product). In this case, if an advice licensee's misconduct causes all of its clients to invest in one financial product, and that product collapses, potentially all of the clients' claims could be aggregated and treated as a single claim. That single claim could then also be subject to the EDR scheme sub-limit, so that the insurer would indemnify the licensee, for all of the claims, only to a total of (for example) $150,000. While this case may be extreme, it does appear to be possible on a strict interpretation of the terms of some policies.

152 In our view, advice licensees whose policies include an aggregation clause and an EDR scheme sub-limit, and who do not cover the potential gap by holding sufficient other financial resources, are unlikely to have adequate PI insurance.

153 It is worth noting that, while the PI insurance policies we reviewed generally allow the insurers to aggregate related claims, insurers have discretion in deciding whether to do so. It appears they consider each claim on its own merits and according to the particular circumstances of the client and the advice given.

154 We expect a significant number of advice licensees hold PI insurance policies that include a claims aggregation clause as well as an EDR scheme sub-limit.

155 Of the four relevant insurers, three have standard terms and conditions that include both an aggregation of claims clause and an EDR scheme sub-limit. As at 31 March 2015, these insurers covered 491 of the 591 relevant licensees. (The standard PI insurance terms of the fourth insurer include a claims aggregation clause but not an EDR scheme sub-limit.)

Misaligned definitions of claim

156 As referred to at paragraph 28, this issue in part reflects a misalignment between how insurers and EDR schemes generally define a claim.

157 EDR schemes apply their jurisdictional limit to each claim even where the circumstances of the subject of the claim are the same and the parties are related. This is referred to by some financial advisers as claim splitting but is endorsed by Regulatory Guide 139 *Approval and oversight of external complaints resolution schemes* (RG 139), which confirms that EDR scheme compensation caps were intended to apply on a 'per claim' basis. RG 139.185 states that:

> This means that separate claims by the same complainant or disputant must not be aggregated by the scheme for the purpose of determining a maximum claim.

Lack of claim aggregation—Excess payable

158 In the preceding section, we set out our concerns about advice licensees' reliance on PI insurance policies that both aggregate interrelated claims and have an EDR scheme sub-limit.

159 Separately (and conversely) to these concerns, there is also regulatory risk where policies do not, or insurers would not (even if they could), aggregate claims. This is because, in these circumstances, it appears that a separate excess would be payable by the advice licensee for each claim.

160 According to RG 126.48, AFS licensees must ensure they have sufficient financial resources to pay their policy's excess and cover any gaps. In Table 4 of RG 126, we state that a factor to consider is whether the excess is at a level the business can confidently sustain as an uninsured loss, taking into account the licensee's financial resources including whether it has sufficient cash flow to meet the excess for a reasonable estimate of claims.

161 The St John report noted at paragraph 2.105:

> To the extent that an excess is payable, the licensee is in effect self-insuring. The larger the excess, the more financial pressure a licensee may come under when faced with a claim. Where a licensee is faced with a number of claims, this pressure will be exacerbated.

162 If a number of claims are made against an advice licensee during the same period, and each incurs an excess of $10,000 or more, the total excess may become unaffordable especially for small advice licensees.

163 This problem should not arise where the policy provides for an aggregation of claims. This is based on our understanding that the terms of most of these policies, where claims are aggregated for the purposes of the limit of indemnity, also aggregate claims for the purpose of the excess.

164 One policy we reviewed is different. It allows for the aggregation of related claims but, where the claims are made through an EDR scheme, it does not aggregate the amounts of excess payable. This may be because, unlike the other policies we reviewed, this policy does not have a sub-limit for claims brought through an EDR scheme.

165 Under this policy, the insurer would be entitled to apply an excess to each and every finding or award by an EDR scheme. Using the example at paragraph 147, if a husband, wife and SMSF each invest based on a single piece of poor advice and that advice results in losses to each of those parties:

(a) the EDR scheme may treat the claims of the husband, wife and SMSF as separate claims;[19] and

[19] RG 139.185 provides that compensation caps apply on a 'per claim' basis. This means that separate claims by the same complainant or disputant must not be aggregated by the scheme for the purpose of determining a maximum claim.

(b) the insurer would be entitled to retain a separate excess for each claim.

If the policy provides for an excess of, say, $10,000, the total excess payable by the advice licensee for these related claims would be $30,000.

Areas of general compliance

166 We did not find any clear failures to meet the requirements in RG 126 apart from the five areas of concern discussed above.

167 For example, we found the following:

(a) *amount of cover*—instances of relevant licensees having a limit of indemnity of less than the required minimum of $2 million were very few—we found three relevant licensees held a PI insurance policy with a minimum limit of indemnity of less than $2 million;

(b) *scope of cover*—broadly, the policies provided the scope required by RG 126—for example, covering EDR scheme awards; and

(c) *exclusions*:

(i) policy exclusions varied significantly and, to a limited extent, were negotiable. Some of the insurers referred to a very limited willingness to write back exclusions, such as for specific types of investments (e.g. managed discretionary account services); and

(ii) other than as discussed above in relation to the fraud and dishonesty exclusion, there was no evidence of any significant instance of PI insurance policies incorporating the exclusions prohibited by Table 4 of RG 126.

168 Each of the relevant insurers confirmed that, among other things, their policies do not have the effect of excluding loss in connection with a claim arising out of a specific ASIC investigation or surveillance, or in connection with a claim arising from incidents notified to ASIC (e.g. through a breach report)—although loss may be excluded if an advice licensee fails to notify the insurer on becoming aware of circumstances that may give rise to a claim.

F Other findings

Key points

Our priority was to gather information about the state of the PI insurance market for advice licensees. We also sought a general understanding of:

- whether there are significant concerns about the timeliness with which claims proceed; and
- why insurers refuse to provide information to EDR schemes about the PI insurance cover they provide to specific advice licensees.

We found the following:

- EDR schemes reported being significantly impeded by their inability to identify which insurer provides PI insurance to an advice licensee, or even whether there is PI insurance that would respond to a claim.
- Insurers may not respond to inquiries from EDR schemes because:
  - EDR schemes have no contractual right to the information;
  - some policies allow insurers to direct policyholders not to disclose insurance details to an EDR scheme; and
  - details of cover are irrelevant to an EDR scheme determination, and disclosure can be a strategic disadvantage in settlement negotiations.
- Otherwise, stakeholders did not report widespread concern about insurers' claims handling, although they mostly had limited experience with claims.

169 Our priority in the review was to gather information about the state of the PI insurance market for advice licensees.

170 While undertaking these inquiries, we also sought to acquire a general understanding of:

(a) whether there appears to be significant concerns about the timeliness with which claims proceed; and

(b) any reason that might explain why insurers refuse to provide information to EDR schemes about the PI insurance cover they provide to specific advice licensees.

171 Our findings, while quite general, are set out below.

Claims handling

172 We asked each of the insurance brokers and industry associations with whom we consulted whether they had any concerns about the insurers' process (including timeliness) for accepting and, where relevant, paying claims. None of the brokers or industry associations with whom we spoke raised any

particular concerns, but this was mostly because they had insufficient experience with making claims to be able to comment.

Communication with EDR schemes

173 More generally, EDR schemes reported being significantly impeded by their inability to identify which insurer provides PI insurance to an advice licensee that is the subject of a claim, or even whether there is PI insurance that would respond to a claim. This information is important for the efficient operation of EDR schemes, including in respect of a scheme's exercise of its discretion to refuse to consider, or continue to consider, a dispute. Generally, EDR schemes will not continue to consider a claim if there is no possibility that the claimant, if successful, would be paid.

174 Rather than directly refuting this, the relevant insurers cited an interest in keeping such information private. Their reasons included that:

(a) EDR schemes have no contractual right to the information—that is, the policy is a contract between the insurer and the advice licensee with no provision for the release of information to a third party;

(b) some policies allow insurers to direct policyholders not to disclose details of their PI insurance to an EDR scheme; and

(c) details of PI insurance cover are irrelevant to an EDR scheme determination, and disclosure can be a strategic disadvantage in settlement negotiations.

175 FOS has also advised us that, in its experience, advice licensees are hindered in their ability to negotiate settlements during the EDR process as doing so would be taken to be an admission of liability under the policy.

176 We acknowledge that there may be legal and/or commercial impediments to the provision of PI insurance details to EDR schemes. However, we think it is important that insurers work effectively with EDR schemes to support, in good faith, the operation of the schemes and payment of determinations. We encourage EDR schemes and the insurance industry to continue to find ways to work towards openly sharing information to the extent possible.

Reasons for denial of claims

177 We also asked the relevant insurers for information about claims made by relevant licensees on their PI insurance policies, including the five most common reasons for denial of claims. In most cases, the insurers provided only a limited explanation of the reasons why claims were denied.

178 Only one of the four relevant insurers recorded any denial of claims between 2012 and 2104. This insurer received 173 claims, from 68 advice licensees, of which 17 were denied. The most common reasons for denial of a claim were:

(a) failure to meet the definition of 'professional services'—in particular, 'approved products'—this appears to relate to advice licensees providing advice in relation to products outside the approved product list and other approval processes;

(b) claim for reimbursement of fees/costs assessment and failure to disclose conflicts or commissions—this appears to relate to the advice licensee's failure to comply with the policy terms requiring it to give an accurate pre-assessment of the costs of performing professional services, and written disclosure of any conflicts of interest, commissions, fees or other benefits received in connection with the provision of professional services;

(c) failure to comply with conditions relating to margin lending and gearing;

(d) retroactive date/advice provided under a different AFS licence—this appears to relate to:

   (i) the timing of the provision of advice—that is, whether the advice was given during the period covered by the policy, which commences at the date known as the retroactive date;[20] and

   (ii) whether the advice was provided on behalf of the relevant licensee, rather than, for example, by an authorised representative of the relevant licensee but on behalf of a different licensee; and

(e) invalid claim notifications.

179 Two of the four relevant insurers reported that none of the claims made by advice licensees against their PI insurance policies in 2012–14 had been denied to date. One of these insurers recorded 12 claims in the period, while the other recorded a total of 136 claims, of which 47 were still open at the date the insurer provided us with its claims data.

180 The fourth insurer was unable to confirm how many of the 382 claims it received between 2012 and 2014 were denied.

181 This insurer did tell us, however, that the most common reasons for a denial of claim were:

(a) the operation of a 'conflict of interest' exclusion—we understand this to be a reference to a clause of the insurer's standard terms which provides that the insurer will not pay a claim directly or indirectly arising from failure to give written disclosure of any conflict of interest, or entitlement to receive a commission on any transaction in which the advice licensee has a relevant interest;[21]

[20] The policies generally cover claims made and reported during the policy period relating to misconduct that occurred after the retroactive date. RG 126 at Table 4 provides that, if the licensee had an immediately previous PI insurance policy, the policy must provide retroactive cover to the earlier of: the retroactive date specified in the immediately previous PI insurance policy; or the commencement date of the first PI insurance policy in the series of continuous policies.
[21] Specifically, the policy refers to a 'beneficial interest or interest as a buyer or seller of securities' except 'a beneficial interest or shareholding of less than 5% in a public listed company'.

(b) a breach of s21 of the *Insurance Contracts Act 1984* (insured's duty of disclosure);

(c) a breach of s26 of the *Insurance Contracts Act 1984* (certain statements not misrepresentations);

(d) the operation of a 'managed investment scheme' exclusion—this is likely to be a reference to a clause of the insurer's policy, which provides that the insurer will not pay a claim directly or indirectly arising from an investment or interest in a managed investment scheme that the insured advice licensee knew, or ought reasonably to have known, was being conducted in breach of the Corporations Act; and

(e) the operation of a statute of limitations.

Key terms

Term	Meaning in this document
2014 Financial System Inquiry	PJC Inquiry into Financial Products and Services in Australia
advice	Financial product advice given to retail clients
advice licensee	An AFS licensee that provides financial product advice on Tier 1 products to retail clients
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
authorised representative	A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee Note: This is a definition contained in s761A.
automatic reinstatement	If the limit of a policy is exhausted before the end of the policy period, on payment of a new premium by the insured, the limit of indemnity is reinstated for the balance of the period to cover any new claims that may arise. The number of automatic reinstatements refers to the number of times the limit of indemnity may be reinstated
Ch 7 (for example)	A chapter of the Corporations Act (in this example numbered 7), unless otherwise specified
CIO	Credit and Investments Ombudsman
client	A retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations
compensation requirements	The requirements in s912B of the Corporations Act and reg 7.6.02AAA of the Corporations Regulations
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001

Term	Meaning in this document
EDR scheme (or scheme)	An external dispute resolution scheme approved by ASIC under s912A(2)(b) and 1017G(2)(b) of the Corporations Act
EDR scheme sub-limit (of indemnity)	The limit of indemnity that applies to any one claim made under a PI insurance policy where the claim relates to an EDR scheme determination
exclusion	A provision of an insurance policy that precludes coverage in particular circumstances
excess	The first part of a loss, which is borne by the insured. The insured is responsible for the loss up to the deductible amount and the insurer pays the remainder of the loss, up to the policy limit
financial product	A facility through which, or through the acquisition of which, a person does one or more of the following: • makes a financial investment (see s763B); • manages financial risk (see s763C); • makes non-cash payments (see s763D) Note: This is a definition contained in s763A of the Corporations Act: see also s763B–765A.
financial product advice	A recommendation or a statement of opinion, or a report of either of these things, that: • is intended to influence a person or persons in making a decision about a particular financial product or class of financial product, or an interest in a particular financial product or class of financial product; or • could reasonably be regarded as being intended to have such an influence. This does not include anything in an exempt document Note: This is the definition contained in s766B of the Corporations Act.
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act
financial services business	A business of providing financial services Note: This is a definition contained in s761A of the Corporations Act. The meaning of 'carry on a financial services business' is affected by s761C.
financial services laws	Has the meaning given in s761A of the Corporations Act
financial services provider	A person who provides a financial service
FOS	Financial Ombudsman Service
FSR	Financial services reform

Term	Meaning in this document
GFC	Global financial crisis
GST	Goods and services tax
insurance broker	An intermediary, who acts on behalf of a person who is applying for insurance. The broker earns a commission from the insurer; however, they have a responsibility to obtain cover appropriate to the needs of the insured. In certain circumstances, a broker can also act as an agent for the insurer in terms of issuing a policy or collecting a premium
licensee	An AFS licensee
limit of indemnity	The maximum amount the insurer will pay in respect of any one claim and all claims in the aggregate made by the insured under a PI insurance policy during the policy period
professional indemnity (PI) insurance	Liability insurance that covers loss arising from an error, omission or negligent act occurring in the conduct of the policyholder's professional business
Pt 7.7A (for example)	A part of the Corporations Act (in this example numbered 7.7A)
reg 7.6.02AAA (for example)	A regulation of the Corporations Regulations (in this example numbered 7.6.02AAA)
relevant licensees	The 591 advice licensees reflected in the information we obtained from the relevant insurers
relevant insurers	The four insurers from whom we obtained more detailed information about the PI insurance provided to 591 advice licensees
retail client	A client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations
retroactive cover	Where a 'claims made' policy extends cover into the past to cover a period of time before the policy was obtained back to the retroactive date
retroactive date	A date in a 'claims made' policy on or after which acts or omissions are covered
RG 126 (for example)	An ASIC regulatory guide (in this example numbered 126)
run-off cover	Cover for claims made after the insurance policy has ended that have arisen from the acts or omissions of the insured during the period of insurance cover. The cover is negotiated upfront at the commencement of the PI insurance policy, rather than separately

Term	Meaning in this document
s912B (for example)	A section of the Corporations Act (in this example numbered 912B), unless otherwise specified
self-insuring	Setting aside a calculated amount of money to form a source of compensation for potential claims
small advice licensee	Advice licensee with around 20 authorised representatives or fewer, and revenue of $2 million or less
SMSF	Self-managed superannuation fund
St John report	Report prepared by Richard St John for the Government, entitled *Compensation arrangements for consumers of financial services* (April 2012)
Tier 1 products	All financial products that are not Tier 2 products
Tier 2 products	General insurance products, except for personal sickness and accident (as defined in reg 7.1.14); consumer credit insurance (as defined in reg 7.1.15); basic deposit products; non-cash payment products; and FHSA deposit accounts
value of an insurance claim	Means the monetary amount or value to be paid out to an insured person (the retail client) under an insurance policy, once the insured person has made a claim on the policy

Related information

Headnotes

aggregation of claims, compensation, defence costs, excess payable, external dispute resolution schemes, fraud and dishonesty cover, last-resort compensation scheme, limit of indemnity, professional indemnity insurance, reinstatement, run-off cover

Regulatory guides

RG 2 *AFS Licensing Kit: Part 2—Preparing your AFS licence or variation application*

RG 126 *Compensation and insurance arrangements for AFS licensees*

RG 139 *Approval and oversight of external dispute resolution schemes*

Legislation

Corporations Act, s912B

Corporations Regulations, reg 7.6.02AAA

Reports

REP 107 *Compensation arrangements for financial services licensees—Research into the professional indemnity insurance market* (December 2006)

Non-ASIC publications

Financial Ombudsman Service Australia report, *An updated proposal to establish a financial services compensation scheme* (May 2015)

Financial System Inquiry final report (November 2014)

Financial System Inquiry interim report (July 2014)

Richard St John report *Compensation arrangements for consumers of financial services* (April 2012)