REPORT 112

Report on submissions to CP 87 Compensation and insurance arrangements for AFS licensees

November 2007

About this report

This report highlights the key issues that arose out of the submissions received in response to Consultation Paper 87 *Compensation and insurance arrangements for AFS licensees* (CP 87) and details our responses to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- 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.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126).

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A Overview/consultation process

Overview

1 We released Consultation Paper 87 *Compensation and insurance arrangements for AFS licensees* (CP 87) on 23 July 2007 to consult on proposals to administer the compensation requirements in s912B of the *Corporations Act 2001* (Corporations Act) and reg 7.6.02AAA of the Corporations Regulations 2001 (Regulations). An Australian financial services (AFS) licensee can generally satisfy the compensation requirements by holding adequate professional indemnity (PI) insurance.

2 To assist in developing our policy, ASIC commissioned a report into the market for PI insurance for AFS licensees: see REP 107 *Compensation arrangements for financial services licensees - Research into the professional indemnity insurance market* (PII Market Report). This report was published with our consultation paper.[1]

3 In CP 87 we proposed that we would administer the compensation requirements to maximise their potential to achieve the objective of reducing the risk that AFS licensees cannot meet retail clients' claims for compensation because they do not have sufficient financial resources (referred to in the consultation paper and this report as the **policy objective**). We also acknowledged that there are some practical limitations in using PI insurance for this purpose.

4 The consultation paper set out some basic principles that would guide our administration of the requirements and also set out some more concrete proposals to give AFS licensees an indication of how we would approach the requirements in practice. These proposals were intended as an indication of our approach for the purposes of consultation, but were not our final policy.

5 This report highlights the key issues that arose out of the submissions received in response to CP 87 and our responses to those issues. For a summary of the changes we have made in our final policy to the proposals in CP 87, see Appendix 1.

6 This report is not meant to be a comprehensive summary of all submissions received. It is also not meant to be a detailed report on every question from CP 87. We have limited this report to the key issues.

7 For a list of the non-confidential respondents to CP 87, see Appendix 2. Copies of their submissions are on the ASIC website at www.asic.gov.au/cp under CP 87.

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[1] For a copy of this report, go to www.asic.gov.au/reports.

Responses to consultation

8 We received around 20 responses to CP 87 from a wide variety of sources including industry associations, investor representatives, AFS licensees (both large and small), their representatives and regulatory bodies. We are grateful to respondents for taking the time to send us their comments.

9 Responses to our consultation paper indicate that many in the financial services industry are looking for certainty from ASIC about the approach it will take in administering the compensation requirements as soon as possible. Therefore we decided to issue a regulatory guide setting out our policy.

10 Responses to our consultation paper also suggest that the standard of PI insurance cover that we proposed in the consultation paper is not currently commercially available for all AFS licensees. We have undertaken further consultation with insurer representatives to understand where the gaps are between what was proposed in our consultation paper and what is commercially available. We have taken this information into account in our published policy.

11 The main issues raised by respondents related to:

- timing of commencement of the requirements;
- our proposal on adequate PI insurance;
- our proposal on partially adequate cover;
- assessment of alternative arrangements; and
- disclosure to consumers.

B Timing

12 Under the Regulations, compensation arrangements need to be in place by:

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

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

ASIC's response

We considered deferring the commencement of the compensation requirements for one to two years to encourage the development of PI insurance policies with a higher standard of cover, including group arrangements, and to give licensees more time to obtain policies.

The transition period has been prescribed in the Regulations. We consider that to continue to defer the requirement for compensation arrangements would result in an unsatisfactory level of protection for consumers.

Therefore, in our regulatory guide, we do not defer the commencement of the requirements but have taken a two-stage approach to implementation. For an implementation period of two years we will require licensees to obtain an insurance policy that complies with a transitional standard based on what we understand is currently commercially available and we will consider an insurance policy that complies with the transitional standard as adequate during the implementation period. During this period we will continue to work with industry to develop insurance products that meet the policy objective. After the implementation period, we will require licensees to obtain an insurance policy that does meet the policy objective.

We have set the implementation period at two years based on feedback in the submissions and to take into account our understanding that insurance policies are renewed on an annual basis and approved by insurers in the year before the policy comes up for renewal.

C Adequate PI insurance

Key points

In CP 87, we set out our thinking on what is an adequate PI insurance policy in terms of the amount of cover, scope of cover and terms of cover. Our proposals were intentionally quite specific to promote discussion of how the new requirements will work in practice. (See paragraphs 14–16).

Overall the submissions raised the issue of availability of this cover. (See paragraphs 18–20).

This section also summarises submissions received on specific features of cover in our proposals. (See paragraphs 21–28).

Our proposal on what is adequate PI insurance

14 In CP 87, we proposed that the requirement that PI insurance be ‘adequate’ means that it is fit for achieving its policy objective as far as practically possible.

15 We also set out more concrete proposals on what we think is an adequate PI insurance policy. We took the view that constructive consultation would be best achieved by being specific about what features of PI insurance AFS licensees will need to have to comply with the requirements.

16 Insurers and industry groups viewed ASIC’s proposals as too prescriptive. Consumer groups and FICS considered that it was important for ASIC to set minimum standards in the industry. Some AFS licensees wanted ASIC to develop standard policy wording with insurers so that they could be certain that the insurance policy they obtained would comply with the requirements.

17 Some groups of licensees submitted that they already have PI insurance requirements, an alternative form of insurance or capital adequacy requirements in place that offer equivalent protection to the compensation requirements.

ASIC’s response

The proposals were intentionally quite specific in order to test our thinking on what would be ‘adequate’ insurance cover to meet the policy objective. Consulting on the proposals was useful because it helped clarify for us what is currently ‘practically possible’.

We consider that it will be important to set some minimum standards for PI insurance policies in the industry. We have observed that it is possible to obtain insurance cover that offers little effective cover available for retail client claims due to policy exclusions, insufficient amounts of indemnity and restrictive policy terms and conditions. We think setting some minimum standards will also assist in achieving a balance between the competing needs for certainty and flexibility that came across in the submissions.

We also considered providing best practice guidance without minimum requirements, but took the view that this would not achieve the policy objective of raising standards of compensation.

In our Regulatory Guide we state that licensees may consider arrangements that have the same broad effect as PI insurance such as trustee liability insurance, group insurance or insurance under a master scheme as PI insurance. However arrangements based on capital adequacy, self-insurance or membership of a discretionary mutual fund will need to be considered by ASIC as alternative arrangements. If licensees have existing cover that was obtained under a different regime with different objectives, licensees will still need to assess whether their existing cover is adequate for the purpose of the Corporations Act.

Availability of proposed cover

18 We proposed that whether a PI insurance policy is adequate depends on:

- the amount of cover;
- the scope of the cover; and
- whether terms and conditions of the cover undermine the overall effect of the cover.

We set out proposals on each of these factors.

19 The overall tenor from the submissions was that respondents believed that the cover ASIC proposed is not commercially available, is unlikely to become available in the short term and may be further restricted in a harder insurance market. It was also suggested that after the requirements commenced, premiums would be high initially while insurers gained experience in pricing the risks.

20 In particular, run-off cover was seen as a key risk area for AFS licensees but not commercially available: see paragraph 28.

ASIC's response

We have considered these submissions and undertaken further targeted consultation to identify what features of insurance are commercially available. It appears that certain features in our proposal such as run-off cover and cover for products not on an approved product list are not currently broadly available to all licensees.

To require these features could have the effect of forcing some licensees out of the market. However, based on the research we have conducted, we understand that these features of cover are important to achieve the policy objective. The PII Market Report suggested that there is a risk that the market for PI insurance may not meet the consumer protection goals of the legislation.

Therefore we will continue to work with industry to develop solutions to achieve the policy objective. We anticipate that further time will be needed for this process.

We understand that other features of cover that may assist in achieving the policy objective are currently available, including cover for breaches of Chapter 7 of the Corporations Act and fraud by agents and representatives (except acting outside approved product lists). Therefore during the implementation period of two years, where a licensee's insurance cover complies with the standard we understand is available, we will consider this as adequate. During this implementation period we will encourage the development of insurance products that meet the policy objective so that licensees can comply with this standard after the implementation period.

Specific features of proposed cover

Per claim cover

21 Our proposal set a minimum limit of PI insurance cover per claim with reference to the EDR scheme limit. Submissions were generally critical of this proposal, suggesting that per claim limits are irrelevant because policies generally rely on the aggregate limits and that this proposal was overly restrictive. We understand from insurers that provision for automatic reinstatements will be more important in practice.

ASIC's response

After further discussion with key stakeholders we understand that per claim limits are less relevant and have not been an issue for denial of claims. We have not set per claim limits in our regulatory guide.

Aggregate cover

22 Our proposal set a minimum of $2 million cover for all AFS licensees with a sliding scale of increasing levels of minimum cover linked to licensee revenue.

23 Some submissions viewed the minimum of $2 million as arbitrary, too high and likely to force smaller AFS licensees out of the market, reducing competition. Other submissions viewed this minimum as insufficient, even for small licensees.

24 Submissions were generally negative on the link to revenue and argued that any scale should be based on the potential risk of loss rather than revenue. The term 'revenue' may be confusing and means different things in different industries.

ASIC's response

We consider that it is important to ensure a minimum standard of protection for consumers.

We have based the minimum of $2 million on the finding by brokers and underwriters surveyed in the PII Market Report that a limit of indemnity of $2 million would cover 90% of individual claims. Consultation with insurers suggests that $2 million cover is highly available for small licensees.

We have decided to continue with our proposal to set a sliding scale of increasing minima set with reference to licensee revenue. We recognise that revenue may not be a perfect test for calculating insurance indemnity limits, but we think it provides a rough guide. We recognise that factors other than revenue will be important for licensees to determine whether they require more than $2 million aggregate cover and we have given guidance on these factors in our regulatory guide, but we think that setting increasing minimum standards will set a higher level of consumer protection overall. We consider that it is important to have a sliding scale of minimum limits of indemnity to reflect that $2 million will be inadequate cover for many licensees and we understand that higher levels of cover are readily available for an increased premium. However we propose to change this test from requiring cover that is two times revenue to cover that is equal to revenue as some submissions suggested that the incremental increases rose too sharply. The concept of revenue is to be determined in accordance with existing accounting concepts.

Scope of cover

25 We proposed that the policy objective and the legislation required a PI insurance policy to cover breaches of Chapter 7 of the Corporations Act by both the AFS licensee and its representatives and to cover awards made by the licensee's EDR scheme.

26 Submissions suggest that most policies would cover an AFS licensee and its agents, or the licensee may require representatives to obtain their own cover and indemnify the licensee.

27 There were mixed responses about the availability and effectiveness of EDR scheme award cover. Several submissions suggested that this cover is becoming less available in certain industry sectors. Some entities have high excesses relative to EDR scheme jurisdictional limits and cover for EDR schemes is limited to a lower maximum than the limit of indemnity, with claims aggregated for the purpose of the limit.

ASIC's response

We consider that it is important that PI insurance policies cover EDR scheme awards. EDR schemes are a main avenue for consumer compensation claims (as recognised by reg 7.6.02AAA). We understand that EDR scheme awards may be considered to be small claims by some licensees and they will wish to self insure for these claims and reserve the insurance limit of indemnity in the eventuality of a larger claim through the courts. This decision to self-insure may be reflected through the policy excess and terms.

Run-off cover

28 The inability for AFS licensees to source run-off cover was a major issue raised in the submissions, although there was evidence that more highly capitalised firms and certain industry categories of licensees can obtain it. Submissions suggested that run-off cover was not automatically available and is generally negotiated at a percentage of the final year's premium. Even if run-off cover is obtained, the increase in ongoing costs may not be affordable and may be passed onto consumers.

ASIC's response

We understand that a major gap in insurance cover currently is that insurance is not available where a licensee becomes insolvent or its representatives move to new licensees.

We think that 6 or 7 years of run-off is desirable (consistent with the statute of limitations). Research conducted for the PII Market Report suggests that the average claim is brought 2–7 years after the incident (by which time a licensee may have ceased business).

However we recognise that this cover is currently not broadly available. Therefore we aim to work with industry to develop products that could improve the scope of this cover or otherwise address this risk. We encourage industry associations to include run-off cover in group arrangements or implement alternative solutions that provide cover with the same effects as run-off cover. We have not required run-off cover in our implementation period policy and have only required one year of run-off cover after that.

D Partially adequate cover

Key points

Where an AFS licensee's PI insurance policy is not fully adequate, we proposed that the licensee could supplement the insurance with financial resources for the purpose of satisfying the requirements. We referred to this in CP 87 as 'partially adequate cover'.

This section summarises submissions on this proposal (see paragraphs 29–31) and our proposal for how licensees should assess what financial resources they require (see paragraphs 32–33).

Our proposal

29 As discussed in Section B, some AFS licensees' PI insurance policies will only partly deliver on the policy objective due to market availability and affordability of this insurance. To address this reality, we proposed that where an AFS licensee's PI insurance was not fully adequate, the licensee could provide for the shortfall in liability using their own financial resources, and we would consider this as adequate for the purpose of the requirements.

30 Submissions expressed concerns that this would impose a significant financial burden on AFS licensees that would be passed onto consumers and did not take into account the licensee's risk management procedures.

31 There was also feedback that making provision for financial resources is currently a standard and necessary part of PI insurance because insured parties are required to have resources to cover the deductible applying to their cover. However, the greater the reliance on the licensee's own financial resources rather than their PI insurance, the grater the risk that the PI insurance will not be adequate.

ASIC's response

We recognise that financial resources are a part of PI insurance and should be considered as a factor in assessing the adequacy of PI insurance cover. An insurance policy without an excess is generally not available; so all licensees who obtain PI insurance will need some financial resources at least to cover a reasonable estimate of the excess payable.

Assessment of financial resources

32 We proposed that AFS licensees could adopt a 3-month cash flow analysis as may be used under Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) to measure what financial resources were required.

33 Submissions suggested that the cash flow proposal was complex to calculate for liabilities that do not crystallise until some time after the breach occurred (long-tail liabilities) and that businesses are unable to commit funds out of cash flow for a maximum potential loss. Some alternative suggestions included support from a parent company and reserves set aside in a super fund.

> *ASIC's response*
>
> We consider that licensees are already required to take into account contingent liabilities in their cash flow projections under (RG 166). We would be concerned if licensees were not complying with this obligation.
>
> The intention behind our proposal was that licensees would consider the risk of successful claims that would not be covered by their insurance policy as well as the potential liability under these claims.
>
> We acknowledge that it is difficult to provide for long-tail liabilities, but think that as part of a licensee's overall risk management procedures, it is important to consider the possibility of claims not covered by insurance and how a licensee will pay these claims.
>
> In our regulatory guide, we require licensees to assess these risks and retain records of how they have assessed the financial resources they require. However licensees have flexibility in how they measure this (e.g. through cash flow, capital, support or another method).

E Alternative arrangements

34 We proposed to approve alternative arrangements only if they give 'no less protection than adequate PI insurance cover'.

35 Most submissions agreed with this proposal. Some submissions suggested that it is problematic to assess alternative arrangements against PI insurance and that alternative arrangements would need to be assessed in the context of the limitations of PI insurance cover and the specified minimum requirements. Further submissions suggested that applications should be compared with commercially available PI insurance, as this would change over time.

36 We asked whether applicants should submit an external expert's report with their application to help ASIC assess whether they provide comparable protection to PI insurance. Some feedback was negative and considered that this would be costly for AFS licensees. Other feedback was positive and suggested expert's reports could be useful in some circumstances.

ASIC's response

Regulation 7.6.02AAA(2) requires ASIC to have regard to the same factors as are prescribed to assess the adequacy of PI insurance. Section 912B(3) also requires ASIC to have regard to whether the alternative arrangements provide run-off cover and the length of the run-off cover.

In our regulatory guide, we state that we will consider what kinds of arrangements we will approve on a case-by-case basis. We have retained the basic principle in our consultation paper that alternative arrangements should afford no less protection than adequate PI insurance (although we recognise that they may provide more protection).

We consider that requiring an expert report for applications for alternative arrangements might make PI insurance more attractive even though the alternative arrangement might offer more protection for consumers. However, we also consider that expert's reports are important to help ASIC understand what protection is given by an alternative arrangement. Therefore, our regulatory guide states that we will generally ask for an expert's report.

F Disclosure to consumers

37 The Regulations require AFS licensees to include a statement in their FSGs and the FSGs of their representatives about their compliance with the compensation requirements. We proposed that, to avoid the risk that clients are misled about the nature of PI insurance, AFS licensees and their representatives should include a list of consumer warnings about PI insurance in their FSGs.

38 Many submissions raised issues about this proposal due to a concern that FSG disclosure would actually cause consumer confusion, increased updating costs and the risk of increased claims. Some submissions expressed the view that consumer-warning messages would not be effective in achieving the aim of the disclosure. There appears to be a tension about whether more or less disclosure is required to avoid this risk.

ASIC's response

We consider that, to achieve its objective, the disclosure in the FSG must be useful to consumers when they are considering the service being offered. We have therefore not prescribed consumer-warning messages in our regulatory guide.

We are concerned that the phrase 'compensation' may be misleading as consumers may misinterpret this to mean that they will be compensated in all circumstances, without taking into account the limitations of insurance coverage and the intended scope of cover under the Regulations. Therefore, in our regulatory guide, we expect licensees to disclose whether they have 'PI insurance' in place.

We also require that licensees disclose to their clients whether their representatives are covered for past work after they cease to work for that licensee, as we understand this has been a major area of consumer misunderstanding in the past.

Appendix 1: Summary of changes to the proposals in CP 87

This table sets out the proposals in CP 87 that have been changed in the regulatory guide. The table does not cover proposals that have been retained in the final policy.

Table 1: Summary of changes to the proposals in CP 87

Proposal in the CP	Policy in the regulatory guide
We set out proposals for adequate PI insurance that would be required from commencement of the compensation requirements.	We have set out an implementation period policy based on what we understand is currently available and will accept this as adequate during a two-year implementation period.
Proposal B1 of the CP - we proposed that licensees should have a per claim limit at least as high as the EDR scheme jurisdictional limit.	There is no minimum per claim limit.
Proposal B2 of the CP - we proposed that compliance with the amount of cover required under the *Insurance (Agents and Brokers) Act 1984* (IABA) would be considered an adequate *amount of cover*.	Insurance that complies with IABA will be adequate during the implementation period generally.
Proposal B3 of the CP – we proposed minimum aggregate levels of cover on a sliding scale based on cover that is two times revenue.	We have changed this test from requiring cover that is two times revenue to cover that is equal to revenue.
Proposals B4 and E1 of the CP - we proposed run-off cover for as long a period as commercially available.	We have not required run-off cover during the implementation period and only require a minimum of one year of run-off cover after that.
Proposal F2 of the CP - we proposed a list of consumer warning messages to be included in FSGs.	We are only requiring licensees to state in their FSGs that they have PI insurance, or alternative arrangements or an exemption and whether those arrangements cover past licensees.

Appendix 2: List of non-confidential respondents

- Assetinsure Pty Ltd
- Association of Superannuation Funds of Australia Ltd (ASFA)
- Australian Bankers Association Inc (ABA)
- Australian Securities Exchange (ASX)
- AXA Financial Planning Limited
- CPA Australia
- Financial Industry Complaints Service Limited
- Financial Planning Association of Australia Limited (FPA)
- Finity Consulting Pty Ltd
- IMF Australia Ltd
- Insurance Council of Australia Limited
- Investment & Financial Services Association Ltd (IFSA)
- Law Council of Australia
- National Insurance Brokers Association (NIBA)
- Securities and Derivatives Industry Association (SDIA)
- Synchron
- The Institute of Chartered Accountants in Australia
- The Intelligent Investor
- WealthSure Pty Ltd
- White Knight Consulting