INSURANCE COUNCIL OF AUSTRALIA

Ms Irene Sim
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The Treasury
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9 July 2012

Dear Ms Sim

COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES

The Insurance Council of Australia Limited[1] (Insurance Council) welcomes the opportunity to respond to the report by Richard St John titled 'Compensation arrangements for consumers of financial services' (the Report).

Overall, the Insurance Council is supportive of the Report and its recommendations. In particular, we agree with the Report's conclusion that a last resort scheme for compensation cannot be justified and that further rigour should be introduced into the current regulatory regime to ensure Australian Financial Services Licensees (licensees) are held responsible for holding current and adequate professional indemnity (PI) insurance cover.

Our responses to the Report's specific recommendations directly relevant to Insurance Council members can be found at Attachment A.

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

Yours sincerely

Robert Whelan
Executive Director & CEO

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. March 2012 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $36.6 billion per annum and has total assets of $115.9 billion. The industry employs approx 60,000 people and on average pays out about $111 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

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ATTACHMENT A

INSURANCE COUNCIL RESPONSES TO REPORT RECOMMENDATIONS

❖ *Recommendation 1: Last resort scheme*
It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.

In previous submissions, the Insurance Council called for a thorough analysis of the need for a last resort scheme before any further consideration of specific models. We are pleased to see such analysis has been undertaken.

The Report concludes a last resort scheme would not address the underlying problems and would compel responsibly managed licensees to cover the cost of bailing out the obligations of failed licensees. We concur that it is preferable to proceed step by step and strengthen the current approach as a first stage

The Insurance Council therefore supports this recommendation.

❖ *Recommendation 2.1: Licensees to demonstrate adequacy of their insurance*
Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.

The Report notes there is a critical need to develop a more robust and effective regulatory system to make licensees responsible for the consequences of their own conduct and that this could be done by placing greater onus on licensees to establish they have adequate insurance cover. The Insurance Council strongly supports this recommendation as the licensee is best placed to understand their business needs and the appropriate level of PI cover.

However, we note the Report states at 4.38 that:

> "It should be a requirement of a compliant policy that the insurer will advise ASIC if a policy is downgraded or cancelled during the course of its term and if a policy is exhausted by claims and is not reinstated. Consideration should also be given to requiring the nomination of ASIC as an interested party in any compliant insurance policy"

The responsibility to advise ASIC of such changes should be on the licensee. Insurers do not have the systems in place to accommodate such a proposal and to implement changes to allow for this would be cost prohibitive, given the annual claims cost of providing cover to financial services providers. Some insurers may cease to provide such cover at all.

In discussions with Insurance Council members, the Reviewer suggested that as part of the annual licence renewal process, the insurer could advise ASIC of any changes in the licensee's PI cover. Such a notification would need to be the licensee's responsibility as the insurer or broker may change from one year to the next and insurers would not have access to details of the previous year's cover.

Furthermore, given the claims made nature of PI policies and the time normally taken to assess and resolve claims for compensation, it is very unlikely that a policy limit would be exhausted during the currency of the policy itself. Even if PI insurers were required to advise ASIC of such an outcome it would normally occur some considerable time after the policy had expired making it impossible to retrospectively "top-up" the insurance cover. Accordingly there would be little point in requiring such notification to ASIC.

While recognising ASIC's responsibilities for consumer protection, the Insurance Council cannot see how ASIC could be listed as an "interested party" on compliant policies. PI insurance is a third party policy, that is, it responds to claims made by policyholders for compensation arising from the provision of their professional service.

The status of "interested party" has no meaning unless the party has an insurable interest. In the case of PI for licensees, ASIC has no insurable interest to protect. Accordingly, Insurance Council members question the point of including ASIC as an interested party under such policies.

As the Insurance Council has previously advised in submissions on this issue, the primary purpose and intent of a PI policy is to protect the insured, not other parties. Insurance Council members do not see merit in any provisions that do not recognise this fundamental tenet.

❖ *Recommendation 2.5.1: Compensation where licensees cease to trade*
In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.

In addition to this recommendation, the Report states:

> 4.111 In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC seems to be moving towards imposing conditions on licensees to leave behind some capacity to meet compensation liabilities that may arise. In the past ASIC allowed licensees to cancel their licence without imposing any conditions upon them.
>
> and
>
> 4.116 In the absence of other steps that may be open to it, ASIC should as proposed above (paragraph 4.111) have regard to the availability of run-off cover when considering the adequacy of a licensee's resources.

We reiterate the point made consistently in Insurance Council submissions on the subject of compensation that the availability of run-off cover is not automatic. Run-off cover is frequently provided to licensees that are considered to present a low level of risk (at the time they cease to trade). Conversely, where the insurer considers the likely risk of the PI cover being triggered is unacceptably high or uncertain (as in the case of a new applicant), run-off cover is not offered.

The Insurance Council therefore supports efforts by ASIC to ensure licensees have some capacity (in the form of capital) to meet liabilities that may arise after they cease to trade.

Unfortunately, in reality licensees in severe financial difficulty are unlikely to have the necessary assets to put aside to pay the compensation claims of wronged consumers.

❖ *Recommendation 2.5.3: Third party rights under licensee's insurance policy*

> *(a) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number. This would assist the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.*
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> *(b) The third party rights provisions of the Insurance Contracts Act 1984 should be extended, as was proposed by a review of that Act in 2004, to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee's professional indemnity insurance policy.*

(a) The Insurance Council has no objection to recommendation 2.5.3(a) provided it is the licensee that is obliged to confirm with ASIC, on annual basis, details of their insurance cover. It would be reasonable for ASIC to exercise a discretion to pass on such information to a retail client who is pursuing a claim against a licensee that is no longer available or fails to respond.

(b) The Report states

> *4.142 Section 51 of the Insurance Contracts Act 1984 (Insurance Contracts Act) provides direct recourse for third parties against an insurance policy held by an insured where the licensee has died or cannot, after reasonable enquiry, be found. The section could be used by a retail client in those circumstances.*
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> *4.143 Those circumstances are however limited and do not cover a case where the licensee is unresponsive to a retail client's award of compensation for other reasons. For example, a licensee who is insolvent or in financial difficulty may have an active insurance policy but no incentive to claim against the policy to benefit the client.*

The Insurance Council strongly opposes recommendation 2.5.3(b) for two reasons.

Firstly, from the experience of members, it is difficult to identify circumstances in which a licensee who is insolvent or in financial difficulty would have no incentive to claim against the policy. Indeed, where a licensee is experiencing financial hardship, they are more likely to claim against their PI policy if possible. Where a licensee is insolvent, the liquidator will have rights to pursue the insurer for reimbursement of compensation claims.

Secondly, we have major concerns with the amendments to section 51 proposed by the Cameron/Milne review. Recommendation 10.4 in the Cameron/Milne Review Report (2004) states:

> *Section 51 of the IC Act should be revised to ensure its interaction with related provisions in other legislation results in consistent operation. The following situation should be addressed:*

- *the insured is alive and can be found but the third party cannot recover under execution of a judgment obtained against the insured, that is, when execution is returned with a nulla bona endorsement; and*
- *a section 48 party is liable and cannot after reasonable enquiry be found.*

Our major concerns with this proposal are as follows:

(a)The insurer may have no opportunity to defend proceedings
Under the proposed change, a third party claimant could potentially recover from an insurer where the insurer has had no opportunity to defend the proceedings. This could occur where the third party claimant brings the proceedings against the insured, who does not notify the insurer of the proceedings or defend them and summary or default judgment is entered or where the third party claimant brings the proceedings against the insured who does not notify the insurer of the proceedings and defends them losing the proceedings. A fundamental assumption underlying any liability insurance is that there exists the opportunity for a substantive defence of any claim.

(b)The subsection could possibly encourage fraud
It would create an incentive for a fraudulent conspiracy between third party claimants and the insured (third party beneficiary) whereby the insured (third party beneficiary) could deliberately allow summary or default judgment to be issued or deliberately put up an inadequate defence to proceedings so to allow the third party claimant a direct path to obtain money from the insurer.

In any event, Insurance Council members advise that they are not aware of any material examples where a solvent licensee has deliberately sought to avoid using their PI policy to respond to claims for compensation and do not understand the Reviewer's concerns in this regard.

❖ *Recommendation 2.5.4: Defence costs*
ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.

The Report notes at 4.169 that if third party consumers could seek remedies against insurers for unreasonable defence costs, insurers might be less likely to defend an action with limited or no prospect of success. The premise behind this conclusion is false – in practice, insurers are less likely to defend an action and more likely to settle a claim where there is limited or no prospect of success.

PI insurers utilise their experience and knowledge to assist in assessing the merit of individual claims and the economics of settlement options. Insurers gain no benefit in incurring additional costs when there is limited or no prospects of a successful defence. Additionally, there should be no inhibition on licensees (and their insurers) to exercise their fundamental legal right of a robust defence of any claim made against them.

RG 126 requires that defence costs must be 'in addition' to the minimum limit or the level of cover must be sufficiently increased to take into account these costs. The Insurance Council submits that this is an appropriately flexible approach. A rigid requirement to offer costs in addition (rather than costs inclusive) is likely to affect both the cost and availability of PI.

In any event, an assessment of likely defence costs should necessarily form part of the licensee's assessment of adequacy of PI cover as required by RG126. An appropriate assessment of potential liability in respect of compensation and defence costs will minimise the incidence of under-insurance. The real issue here is not the reasonableness or otherwise of any defence costs but the purchase of an adequate PI policy limit.

❖ *Recommendation 2.5.5: External Dispute Resolution scheme processes*
Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues discussed in Chapter 2.

The Insurance Council shares the concerns relating to the operation of EDR schemes as outlined at 2.180 of the Report. Operational rules and procedures developed for dealing with small and relatively simple claims can be inappropriate for complex or high value claims.

Whilst Insurance Council members acknowledge that FOS has been willing to consult with scheme participants and respond to industry concerns, the Insurance Council supports the recommendation for a more systematic consideration of FOS's operation.

❖ *Recommendation 3.1: Review regulation of product issuers*
As a matter of strategic approach, it would be timely to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.

It would be appropriate also, in the course of any such review, to direct more attention to the responsibilities of licensees who provide financial products for retail clients. While the review has not had an opportunity to test these proposals, a first step might be to consider measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

> *(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.*
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> > *Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing. Amongst other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of investing in the product.*

A stronger approach by managed investment schemes to the management of risk of fraud, particularly by employees or representatives, might also be sought.

(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.

This might apply to such terms as capital guaranteed, capital protected, conservative, balanced, diversified, growth, defensive, fixed interest, or hedged, as well as other like descriptors.

(c) While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

The Insurance Council supports this recommendation as it is likely to discourage the development and sale of financial products to inappropriate segments of the investor market.

❖ *Recommendation 3.2: Responsibility of product issuers through EDR schemes*
Some rebalancing of responsibilities of product issuers and financial advisers towards retail clients could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.

Further, consideration should be given to the clarification of clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the 'management of the fund or scheme as a whole'. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.

The Insurance Council supports this recommendation. A more equitable allocation by FOS of responsibility to compensate for investor losses as between financial advisers and product issuers should result in financial advisers bearing less of a burden for financial compensation. This would facilitate a reconsideration of PI insurers of their willingness to offer cover to financial planners and at what premium.