

21 November 2002

Ms Ruth Smith
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Ms Smith

Compensation For Loss In The Financial Services Sector

The National Insurance Brokers Association (NIBA) makes this submission in response to the Treasury issues and options paper on compensation for loss in the financial services sector.

NIBA strongly supports the continuation of professional indemnity insurance as the means of compensating insurance brokers' clients for loss. The current system of PI for insurance brokers has been an efficient and an effective means of compensation for a number of years offering a very high level of protection to the clients of insurance brokers.

The insurance broker sector is different from other financial services sectors and its particular features need to be taken into consideration in compensation arrangements.

PI is simply part of a package of consumer protections measures that has been developed for insurance brokers' clients over a period of twenty years. The package includes:

- a. Effective regulation of insurance brokers.
- b. A proactive association in maintaining competency and ethical standards of members.
- c. Legislative basis for PI. The minimum requirements are outlined in legislation and Regulations and include,
 - i. The policy must be acceptable to ASIC.
 - ii. The policy must contain a clause indicating that claims under the policy will be determined according to Australian law.
 - iii. Minimum levels of cover and deductible.
 - iv. A requirement that the PI policy should not be able to be cancelled by the insurer for the failure of the insurance broker to comply with the duty of disclosure in entering into the contract or for misrepresentation before the contract was entered into.

- v. A requirement that the insurer is unable to cancel the policy (where they are able to do so) until three days after notifying ASIC of the intention.
- d. Active enforcement of the PI requirements. ASIC actively enforces the requirements and if a broker does not have the required PI they are not able to carry on business.
- e. Strong requirements in relation to clients' funds.
 - i. Clients' funds are protected by a trust arrangement.
 - ii. Under section 985B of the FSR Act the insurer rather than insured bears the risk of funds held by an insurance broker.
 - iii. The issuer of the product is supervised by APRA.
- f. The PI arrangements are integrated with the external dispute resolution mechanism.

This package of measures has delivered strong consumer protection and, while in theory there may be some gaps in the arrangements, these have not proved to be significant in practice.

NIBA would be concerned if the review led to changes in the current arrangements for insurance brokers that simply increased costs and yet provided little or no increase in the level of consumer protection.

The risk of consumer loss varies significantly between financial services sectors and it may not be practical for a single system of compensation to apply equitably to all sectors. NIBA has no difficulty with applying different arrangements to different sectors.

In the attachment to this letter NIBA has provided answers to the questions posed in the paper.

If there is any further information you require please do not hesitate to contact me.

Yours sincerely

Noel Pettersen
Chief Executive Officer

NIBA's Response to Specific Questions Asked by Treasury in its Paper on Compensation for Loss in the Financial Services Sector

Principal Issues

1.Q. Can you provide evidence of the nature and extent of losses suffered by consumers of financial services to assist us to understand the extent of the problem?

A. There is no evidence of any significant losses being suffered by customers of insurance brokers. The fact that a number of insurance brokers have been deregistered or suspended cannot be taken as evidence of loss. The compulsory PI arrangements for insurance brokers together with a number of provisions in the Insurance (Agents and Brokers) Act 1984 that have been continued under FSRA have ensured a very high level of protection for the clients of insurance brokers.

2.Q. Is requiring compensation arrangements in the financial services sector justified?

A. Some form of compensation arrangements is justified. The PI arrangements for insurance brokers have been a very cost efficient and effect method of protection. While the current arrangements for insurance brokers have been satisfactory others sectors of the financial services sector may require a different approach. The protection should be reasonable but not absolute.

3.Q. What is the purpose of compensation arrangements which are required by legislation?

A. The purpose of compensation arrangements can vary between market sectors. In relation to insurance brokers professional indemnity insurance provides consumer protection in relation to the negligence of the broker. It is not intended to cover such situations as the failure of the underwriter or the insolvency of the broker. There are other mechanisms that deal with these issues. The situation in relation to insurance brokers can be summed up by the Law Reform Commission in *Report No 16 Insurance Agents and Brokers* where it states that professional indemnity insurance provides some measure of protection against the risk of sudden, possibly catastrophic loss arising from the negligence of a broker.

4.Q. (a) In what circumstances should compensation arrangements be required in relation to a financial services licensee?

(b) Should different criteria or different mechanisms apply depending on whether the financial service provider is unable to pay/insolvent?

(c) Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent?

A. NIBA's comments that follow relate only to insurance intermediaries and have regard to all of the consumer protection mechanisms currently at work to protect insurance brokers' clients. NIBA believes that the major circumstance where compensation should be paid is where there has been a failure to enter into and complete transactions according to the client's instructions. No distinction should be made between solvent and insolvent intermediaries.

5.Q. *Who should be entitled to claim?*

A. NIBA suggests that the compensation arrangements be available to both retail and wholesale clients. The maximum benefit should however be capped. This is consistent with the PI arrangements that currently apply to insurance brokers.

Financial services licensees

6.Q. *What compensation requirements should be imposed on financial services licensees?*

- (a) *Should financial services licensees be required to have professional indemnity insurance? Are there other appropriate mechanisms which could be an alternative at the option of the licensee?*
- (b) *What should the mechanism adopted be required to cover?*

A. NIBA believes that PI should form the basis of any compensation arrangements. It is far more effective than the current deposit arrangements. It involves a 'user pays' element in that licensees' premiums are based on an assessment of their risk by the market. This is usually not possible with a statutory scheme, which by necessity has to rely on broad pooling arrangements. The mechanism should cover broad risks only and should not attempt to cover every possible contingency. Because the risks differ in the various sectors of the financial services industry the arrangements may also need to vary between sectors.

7. Q. (a) *What, if any, difficulties are being experienced in the financial services sector with the cost and availability of professional indemnity insurance? For example is run-off cover available?*

(b) *What, if any, difficulties have consumers had in being compensated from professional indemnity insurance.*

A. While the cost of PI has increased significantly over the past 12 months it still remains readily available to insurance brokers. The exception is brokers with poor claims experience or those that have had their ASIC license suspended or cancelled. While run-off cover is not automatically available through the NIBA PI facility it is available for individuals in the market place. Consumers do not appear to have suffered because of a lack of automatic run-off cover in the NIBA facility. The PI arrangements for insurance brokers have worked very well for almost 20 years. They have ensured a high level of consumer protection. Theoretically there are gaps in the cover but these have not proved to be significant in practice.

Market licensees

NIBA has no expertise in relation to Market licensees and accordingly has chosen not answer questions 8 and 9.

A broad statutory scheme

10. Q. *Do the financial services industry and consumers consider that a broad statutory scheme is warranted?*

- A. NIBA does not support the introduction of a broad statutory scheme that would cover insurance brokers. The existing PI arrangements for insurance brokers are working well and do not need to be replaced by or be supplemented with a broad statutory scheme. A statutory scheme should only be contemplated if there was market failure and the private sector was unable to supply the necessary compensation by way of insurance.

11. Question 11 is contingent upon support for a broad statutory scheme.

Secondary Issues

If a statutory scheme were warranted

12.Q. *Who should operate the scheme?*

- A. If there were to be such an arrangement it should be operated by industry. There may need to be more than one industry scheme.

13.Q. *What special governance and accounting requirements should apply?*

- A. Any such requirements would depend upon the nature of the arrangements. The scheme would need to be transparent and fully accountable to participants.

14.Q. *Could the scheme cover financial services in relation to all products and sectors of the industry?*

- A. The risk of consumer loss varies significantly between industry sectors and equity requires a different approach be taken for the different risks involved. The risks vary, between product producers and intermediaries, between savings and risk products, between market and non-market licensees and with products and practices. Individual risks need to be assessed and a separate approach taken with each risk.

15. Q. *If market licensees no longer had to make compensation arrangements, what should happen to the funds in the National Guarantee Fund and the exchange fidelity fund?*

A. This is not an area where NIBA has relevant expertise but it would appear appropriate that the funds should be dispersed in accordance with the constitutional documentation.

16.Q. *How should it be funded initially and in the longer run.*

A. Funding should be on a commercial basis having regard to the risks involved with each licensee. Initially it may be necessary to have some form of guarantee, by government or industry.

17.Q. *What would be the appropriate powers of the operator?*

A. The appropriate powers would depend on the nature of the scheme. The issues would, however, be complex and require detailed analysis. Clearly any fund would need to be prudentially supervised and there would need to be procedures for paying claims.

Other issues

18. Q. *Should special provisions be made for the financial services licensees which are regulated by APRA, have high financial requirements or high market capitalization, or have the requisite connection with such a body corporate?*

A. NIBA does agree that a case can be made for certain organizations to be exempted from the compensation arrangements. Those subjected to APRA regulation could be exempt provided APRA in its supervision recognized the relevant liabilities and potential liabilities. Licensees that are only associated with an APRA regulated body should, however, not receive any exemption. The exemption should only relate to APRA regulated bodies.

19.Q. *How should the loss be measured and should consequential loss be covered.*

A. Compensation should be for the loss suffered (including any consequential loss) by the client that would be awarded by a Court.

20.Q. *Capping:*

- (a) Should there be capping of the amount paid in response to a claim.*
- (b) If capping is accepted what form would be appropriate.*

A. NIBA believes that capping is essential. Without capping the scheme would be open-ended and premiums would increase significantly. The capping arrangements for insurance brokers have worked well. Brokers are required to have PI equal to or more than 15% of premiums collected with a minimum cover of \$1 million and a maximum cover of \$5 million.

21.Q. *What is the appropriate connection with Australia?*

- A. The connection with Australia depends upon the nature of the compensation mechanism. With PI for example the claims against the policy should not be restricted to those relating to Australian residents. The issues involved with a mandatory statutory scheme are however different and it may be appropriate to restrict benefits to Australian citizens if there was to be such a scheme.

22.Q. *What is the appropriate relationship between compensation arrangements and external dispute resolution schemes?*

- A. NIBA believes that there should be a relationship between the compensation arrangements and the relevant external dispute scheme so that there is a reasonable expectation that funds will be available to cover decisions of the dispute resolution tribunal. This is in fact what happens in relation to insurance brokers. The broker's PI insurer agrees to be bound by decisions of the tribunal up to \$50 000 which is the binding limit for the brokers' dispute resolution scheme.

23. Q. *Should excess funds in a statutory scheme be available for financial industry development purposes, or should there be mechanisms to discourage the build up of excess funds?*

- A. If there is to be a single statutory scheme that included insurance brokers, NIBA would prefer the scheme to have a single purpose, compensation, and for any surplus to be returned to contributors. This could be done by way of a reduction in future premiums.

24.Q. *Should there be time limits for claiming and, if so, how should they be set?*

- A. The nature of any time limits would depend upon the nature of the scheme. For example the time limits in relation to PI claims are usually determined by statute. Time limits should be reasonable having regard to the purpose of the scheme.

25.Q. *What is the appropriate level of detail in the legislation?*

- A. It is appropriate for the broad requirements to be specified in legislation and for detail to be prescribed by way of Regulations. Some flexibility of administration should also remain with ASIC. The current PI arrangements for insurance brokers have worked well. Over the years some minor adjustments have been made to the NIBA PI facility to take account of changing market conditions. The flexibility has existed for such minor changes to be made without recourse to changing the law or Regulations.

REPRESENTING PROFESSIONAL INSURANCE BROKERS