ILLUSTRATION: JUPITER IMAGES

PI BATTLE COMMENCES

Written by: *VICTORIA YOUNG*

Compensation has become an industry-wide issue. Financial advisers are still feeling the aftershocks from the collapse of Westpoint two years on. The Financial Industry Complaints Service (FICS) calculates that about 63 licensees had 3000 clients with between $300 million and $400 million invested. Each has an average potential exposure of between $4.75 million and $6.5 million. The industry is yet to discover the full ramifications of the 2007 product failings of Fincorp, Australian Capital Reserve and Basis Capital, but estimates are put at more than $1 billion. Centro Properties Group could yet prove to be the first casualty of 2008.

Another iceberg ahead is the share market downturn. With $300 billion wiped off the Australian Securities Exchange since November 1, investor morale has taken a pummeling.

History shows that when returns plummet, the number of investor complaints soars. The situation is exacerbated by FICS' decision to increase its monetary limits for investment complaints from $100,000 to $150,000 from July 1. FICS expects to receive up to 10 per cent more complaints. It handled 1200 complaints in 2007.

ASIC's objective of making professional indemnity (PI) insurance compulsory from July 1 was to reduce the risk that a retail client's losses cannot be compensated by the licensee due to the lack of financial resources, according to ASIC Regulatory Guide 126 (RG126). But there are very real fears in the industry that despite PI insurance being intended to cover the insured – the licensee – for losses resulting from poor quality services and misconduct by a principal or authorised representatives, it will be misinterpreted.

"RG126 notes that PI insurance is not intended to cover product failures or general investment losses or claims for losses solely as a result of failure of the product issue. I find it interesting to put that in there," Alexis compliance and risk solutions principal Christina Kalantzis says.

"In my experience whenever a product fails there is a sharp increase in consumer complaints in the guise of 'inappropriate advice' and 'not in accordance to a client's risk tolerance level'.

"Recently, I have managed several complaints on behalf of financial advisers where clients have lodged a complaint seeking compensation for a product failing, yet the advice was, in my opinion, appropriate. Clients are becoming savvier about how to get access to PI and that's my concern about this whole thing."

Legal experts contacted by *IFA* confirmed PI insurers had paid claims brought by Westpoint investors.

"My concern is that what Westpoint has done is that it's highlighted to clients, perhaps not rightly so, that they have the right to make a claim when a product fails," Kalantzis says.

ADEQUATE PI COVER
– the nuts and bolts

The FPA is set against ASIC's aggregate PI insurance claim limit determination (see table one). FPA chief executive Jo-Anne Bloch says the measures would increase PI insurance premiums disproportionately, which would hit small to medium-sized licensees hard and have little consumer benefit.

"We draw [ASIC's] attention to the fact that any increase in PI cover will result in an additional cost, which ultimately will be passed on to consumers. Thus, while it may be argued that some consumers will be better protected, it is also clear that fewer consumers will be able to afford good advice and that they will be exposed to greater risk," Bloch says.

The FPA recommended ASIC consider its principal member rules that require at least $2 million aggregate PI claim cover, but not less that 50 per cent of the estimated gross income from financial planning.

After two years, Australian financial services licence (AFSL) holders will be required to hold a higher standard of PI insurance cover, including previously uninsurable events. The scope of cover must include fraud by the licensee and representatives, external dispute resolution (EDR) scheme awards, advice on items not on the approved product list and run-off cover for at least a year.

The prescriptive nature of ASIC's adequate PI insurance has been heavily criticised by key players in the insurance and financial planning industry.

"Fraud and dishonest acts can present difficulties for PI insurance insurers, particularly where the act is performed by a person who would be a beneficiary under the policy. It is a basic tenet of insurance that a person should not be compensated for their own dishonest act," National Insurance

TABLE ONE:

TIME FRAME
Implementation of minimum requirements by July 1, 2008.

AMOUNT OF COVER
- *Licensees with revenue less or equal to $2 million – minimum aggregate limit $2 million.*
- *Licensees with revenue more than $2 million – minimum aggregate limit equal to actual expected revenue from retail clients. The minimum level is capped at $20 million.*

SCOPE OF COVER
PI insurance must cover:
- *loss or damage suffered by retail clients because of breaches of chapter 7 of Corporations Act;*
- *breaches by licensee and representatives;*
- *fraud by licensee and representatives; and*
- *EDR scheme awards (including the FICS monetary award limits increased to $150,000 for non-life insurance complaints and $280,000 for life insurance complaints).*

EXCLUSIONS
PI insurance policy may not contain exclusions for any of the following:
- *loss caused by conduct of representatives;*
- *fraud and dishonesty by agents and representatives;*
- *claims for misrepresentation of services;*
- *claims arising from incidents notified to ASIC (for example, breach register); and*
- *EDR scheme awards.*

PERSONS COVERED
Policy must cover licensee and all representatives.

AUTOMATIC REINSTATEMENTS
The policy must include at least one automatic reinstatement.

LEGAL COSTS
Must be payable in addition to the policy limit if minimum aggregate claim limit or level of cover selected.

RETROACTIVE COVER
Retroactive date at least the same as expiring policy.

RUN-OFF COVER
Required for as long as possible, but at least a year. Compulsory after January 1, 2010.

FINANCIAL RESOURCES/ EXCESS
Financial resources available to confidently sustain as uninsured loss, for example, excess, gaps in cover.

APPROVED PRODUCT LIST
From January 1, 2010, PI insurance must cover products not on APL for agents acting outside the APL in legitimate switching cases.

SOURCE: Based on ASIC RG126 table 4

Brokers Association of Australia chief executive Noel Pettersen says.

Axa advice and licensing national manager Simon Wallace, representing Axa Financial Planning and Charter Financial Planning, says he foresaw commercial issues for smaller licensees in obtaining PI insurance with all of ASIC's key features and no exclusions.

Insurance Council of Australia executive director and chief executive Kerrie Kelly says: "Insurance Council members have consistently explained to Treasury and ASIC, over a number of years, that expansion of PI insurance along the lines set out in the paper is not commercially feasible."

WILL THE INSURERS COME TO THE PARTY?

Dual Australia national underwriting manager Leo Abbruzzo is reviewing his PI insurance coverage. He is already certain his company will not be able to cover some of the features of ASIC's adequate PI insurance.

"The changes have put pressure on the market in the sense that there are not too many players already; there may be some underwriters that might drop out. It's already a tough PI market," Abbruzzo says.

This is echoed by Apex Insurance Brokers managing director Daniel Johnson. Several underwriters are reviewing their position in financial planning PI, Johnson says.

The market has already dwindled from 37 insurers before the collapse of the nation's largest PI insurer, HIH, to just five – Dual Australia, Dexta Corporation, Vero, AIG and Chubb Insurance Australia, which only services Victoria. Last year QBE stopped writing new PI insurance policies for financial planners.

The general insurance market has been soft for the past four years; there has been great underwriting capacity and flexibility, and premiums have bottomed out thanks to insurer competition. However, the PI insurance market is on a downward spiral.

"If PI insurers are not prepared to offer a specified form of cover in these market conditions, it is highly unlikely they will do so when the inevitable 'hard' phase of this insurance cycle arrives," Assetinsure national manager of professional risks Ewen McKay says.

Clients, plaintiff lawyers and regulators' expectations of PI insurance have become unrealistic and unsustainable, McKay believes. The protection of clients and consumers is simply a happy consequence of the actual purpose of PI insurance.

Abbruzzo says the tough PI insurance requirements could have the effect of weeding out the "bad planners". "If you can't get insurance, you can't give advice," he says.

He then speculates that it could cause market consolidation if smaller planning groups are priced out of PI and therefore have to join a larger group or relinquish their AFSL. Association of Financial Advisers (AFA) chief executive Richard Klipin also sees financial planning business consolidation as a likely effect of the new PI rules.

Larger, highly-capitalised groups can apply to ASIC for exemption from PI, but independently-owned licensees and small to medium enterprises (SME) will face greater PI costs. Smaller groups have few choices – absorb it, pass it on to their authorised representatives, who will in turn pass it on to clients by driving up the cost of advice, or do a mixture.

"It may be that depending on the outcome of this, smaller licensees may choose to join some of the larger institutional groups," Klipin says.

"From our point of view that debate, that consultation with ASIC, still needs to take place. I don't think they intended to set up an industry that might be disadvantageous to SME licensees. What might come out of this is that's what exactly has happened. And a fair, open and robust market is one that has a choice of options for advisers and a choice of options for clients for what models they operate in."

ROCKETING PREMIUMS

Count Financial chairman Barry Lambert says: "I think premiums are going to go through the roof. Personally, I think it's very simple: every time there's a market downturn, PI claims go up.

"I think it's going to be an enormous problem. It'll be a feeding frenzy for the insurers. This is just going to suck the life out of licensees.

"The reality is that premiums are going to go up for fully compliant advisers to cover all those who are not compliant and advise on [products like] Westpoint, Fincorp and Basis Capital. Premiums will go up to subsidise other people's exposure."

The major PI insurance policy renewal period is between March and June. PI broker Johnson says AFSLs should brace themselves for increased premiums. The 10 per cent to 20 per cent no claims policy reductions

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are history. Johnson expects premiums to increase by up to 10 per cent. And that's provided the licensee has not had any compensation claims.

To save members from rocketing premiums, the AFA is in discussion with PI insurers and brokers to devise an offer.

"We're looking at all the options. There's probably a number of models that will come out of those investigations. The main thing is that members can get access to people who can provide the cover and provide a good solid contract at a reasonable price," Klipin says.

Boutique Financial Planning Principals' Group president Claude Santucci is concerned about increasing PI premiums and the availability of PI coverage for members.

"We're speaking with the insurers, but nothing's really coming on the horizon. Getting PI insurance is beginning to get a bit awkward, but PI insurers want to do the right thing," Santucci says.

PI IS GOOD FOR BUSINESS

Melbourne-based Dover Independent Financial Advisers trumpets its PI insurance arrangements to attract advisers to its network.

"We use it as a marketing tool to attract authorised representatives. Before our authorised representatives come on board it's often the first question they ask: 'Do you have PI insurance? Can you help me get it?'" Dover Group chief executive officer Adrian McMaster says.

Coincidentally, as an independent dealer group that is entirely fee for service, Dover had difficulty finding a PI broker that understood its model.

"It's probably fair to say the PI world doesn't understand fee-for-service remuneration," McMaster says.

After engaging broker Holdfast in Adelaide, McMaster found that PI Insurers considered fee-for-service less risk. Dover is insured by Dexta.

"Because Dover is fee for service, it's less likely to experience conflicts of interest. Schemes like Westpoint are not going to get a run with us because no-one would be paid more for recommending it, so there's no incentive to take that risky line," he says.

"There's not as much potential for mischief. As chief executive I sleep quite easily at night."

ALTERNATIVE ARRANGEMENTS

Since 2004, listed dealer group Count Financial has self-insured. Four years ago, in a hard PI market, the licensee was shelling out around $1 million in annual insurance premium.

"The cover didn't have any value. We were just wasting $1 million of shareholders' money," Lambert says.

Count's policy is tailored to its business, client and risk requirements. Its high claim excess has so far gone untested, with just nominal administrative claims being made so far. Count plans to continue the arrangement and apply for an exemption from PI insurance under RG126. It will apply on the grounds that it has sufficient capacity to grant consumer compensation because it is a profitable business that has been self-insuring with no problems for four years, it has options that mature each year and could raise extra money from the stock exchange if required.

Commonwealth Bank of Australia-owned dealer group Financial Wisdom also self-insures. Financial Wisdom general manager Tim Browne says the issue of PI insurance is one of the first things financial advisers ask about. Planners are usually surprised to find Financial Wisdom self-insures and the cost is included in the licence fee.

Self-insuring is not something Australian Financial Services Group (AFS) would consider. AFS has had a single policy with Liberty International Underwriters since 2004. AFS chief executive Peter Daly warns other AFSL holders against chasing cheaper premiums in a soft PI insurance market as it is exceptionally important to establish a relationship with an insurer.

"I've spent four years building the profitability, the last thing I want is for something to come out of leftfield, like the kind of problems PIS [Professional Investment Services] and DKN have had, and wipe me out. The key factor is prudence," Daly says.

"Because we have a group policy, we don't have any day-to-day concerns. The majority of advisers see PI insurance as a necessary evil, although our advisers only think about it once a year when they complete their policy declaration."

INSURERS AND FICS

Cover for compensation awards made by the EDR scheme FICS is a particular sticking point for insurers, according to McKay.

PI insurers have been generally supportive of FICS in its function of conciliating disputes, as long as the AFSLs have consent from

BARRY LAMBERT

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>
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> *Count Financial*

their insurer. However, insurers have major reservations about the fact there is no right to appeal (except on procedural issues), that determinations do not create a binding precedent and adjudicators and panels are not bound by rules of evidence.

According to McKay, in the past PI insurers have provided cover to licensees for FICS determinations on the basis that the limit is relatively low, insureds' policy excess covers most of the award, and insurers have placed low aggregate limits on FICS claims, eliminating their exposure to multiple FICS claims in a single policy year.

"Insurers have been able to absorb cover for FICS claims without material adjustment to their insurance models. FICS [monetary limit] increases weaken the mitigating factors. Insurers have to decide themselves, but most insurers would not be supportive of significant increase – and certainly not to $280,000," McKay says.

The specialist PI insurance broker was involved in group consultations between PI insurers and FICS during the first half of 2007 and can make firsthand observation of feedback from insurers to FICS.

"The uncertainties inherent in the FICS jurisdiction are amplified if an insurer is exposed to multiple FICS claims from a product failure, such as Westpoint, with no prospect of appeal in the event of a perceived error by FICS is replicated across multiple determinations," McKay says.

"Accordingly, the higher FICS limit will make insurers less amenable to providing cover for FICS determinations and certainly motivate them to restrict the aggregate limit available for FICS matters."

There is a widely held belief, shared by both Daly and Lambert, that FICS has a consumer bias. Daly, who says FICS is a "highly political" subject for him as his father is FICS chairman, believes FICS deals directly to the letter of the law but has a degree of consumer sentiment, particularly in relation to Westpoint.

He says he fears that black and white rule, or a one-size-fits-all approach, could evolve. He says FICS really needs to examine each case very carefully.

"Just because someone recommends Westpoint, doesn't mean that someone has done the wrong thing," he says.

In a bid to improve understanding of the EDR scheme, FICS will hold a series of open forums starting in Sydney on February 29.

FICS members can question the complaints scheme's decision-making panel on judgment specifics. FICS chief executive Alison Maynard recognises there is a lack of understanding about FICS' processes.

AVOID BEING TRIPPED UP BY PI

The regulator has handed the responsibility to the licensee to decide whether its PI insurance arrangements are adequate. The Corporations Regulations require licensees to have adequate cover for FICS claims and consider the volume of business, kind of clients, type of business and number of advisers when assessing PI cover. The regulator encourages AFSLs to review business operations, identify risks and mitigate against them.

"I'd encourage people when they do their annual AFSL audit that they also do a PI review. The PI review should take into account any additional service offerings the AFSL has taken on, any new products that they're providing advice on and whether adviser numbers have increased. These actions are risk trigger events and need to be insured for," Kalantzis says.

ASIC recommends licensees engage compliance professionals and their insurance brokers to check whether PI is adequate or not in line with the scale, nature and complexity of the business. □

ADRIAN McMASTER:
PI insurance as marketing tool

PETER DALY:
key factor is prudence

TABLE TWO: PI INSURANCE REVIEW PROCESS

STEP 1:	STEP 2:	STEP 3:	STEP 4:	STEP 5:	STEP 6:	STEP 7:
Assess your business. Review your business, taking into account any proposed changes to the business. Review your claims history (if any) and risk management procedures.	*Assess potential liability. Determine the maximum liability that has, realistically, some potential to arise (that is, estimate the worst loss scenario per client, the number of claims that could arise from a single event and the number of claims that might be expected during the policy period).*	*Approach insurers/ brokers. Ask insurers or insurance brokers for a list of key policy features, exclusions and available extensions. Check terms and conditions.*	*Assess the amount of cover required. Consider whether the amount of cover is adequate. It should at least meet the minimum ASIC requirements.*	*Assess the scope of cover. Consider whether the scope of cover is adequate.*	*Review policy terms and exclusions. Review the policy features using the questions in table one. Identify any gaps in cover.*	*Consider financial resources. Check you have the financial resources to pay the excess on the estimated number of claims and cover any gaps and legal costs (if necessary). Consider how you will cover these claims and retain records of the assessment (for example, through capital, cash flow, overdraft, support).*

SOURCE: Based on ASIC RG126 table 3