Chapter 3: Compensation arrangements in practice

This chapter reviews the practical operation of the compensation arrangements for retail clients of financial service licensees. It draws on available data and preliminary input from licensees, insurers, regulators and a dispute resolution scheme that deals with providers of financial services. It discusses the market for professional indemnity insurance for financial services; access to and costs associated with professional indemnity insurance for licensees; the role and limitations of professional indemnity insurance in assuring the provision of compensation; and circumstances in which retail clients may be unable to recover awards of compensation against licensees:

- Given the reliance on professional indemnity insurance as a basis for compensation, the availability and cost of appropriate cover in the market is a relevant consideration.
- There appears to have been a hardening in the professional indemnity insurance market for some, but not all, financial services providers in recent years. On the supply side, the number of insurers providing cover for financial advisers has contracted.
- The need to maintain insurance cover has an impact on the cost of services such as the provision of financial advice. While there does not appear to have been an increase in the premiums for professional indemnity insurance across the whole financial sector, anecdotal evidence suggests that premiums for some licensees, such as financial advisers, have increased substantially in recent years.
- Claims lodged by financial service providers under professional indemnity insurance policies appear to have increased significantly, particularly from 2008 onwards.
- Professional indemnity insurance assists licensees to meet claims by clients in many cases, but has some limitations in ensuring clients receive compensation to which they are entitled. Insolvency issues, policy exclusions and gaps in the cover that the market will provide, as well as caps on the amount of cover taken out, limit the extent to which professional indemnity insurance can ensure that clients are in fact compensated where they succeed in a claim against a licensee.

- Where a licensee does not have a policy that responds to a successful claim, the licensee remains under an obligation to meet that claim. A client's prospects of recovering compensation will depend on the available financial resources of the licensee. The client is exposed to the risk that the licensee may no longer be trading, have become insolvent or is otherwise unable to pay.

- While precise data is hard to come by, there are cases where retail clients succeed in obtaining awards of compensation but are not able to recover that compensation. There could well be other cases where clients do not pursue claims because the chances of achieving payment of any award are remote.

Market for professional indemnity insurance

3.1 Ahead of the introduction of the requirement for professional indemnity insurance, ASIC undertook research into the Australian market for such insurance, including the availability and affordability of cover for licensees.[1] The report on this market research concluded that:

> ... the market for professional indemnity insurance is well supplied with a wide choice of providers, policies and special schemes. It is highly competitive on price with few concerns about affordability or premium levels. It is not expected that licensees, who are not presently insured, will experience difficulty in obtaining [professional indemnity insurance] unless they have a poor track record or present unusually high risk exposure ...
>
> the immediate outlook for the market is positive, with predictions that the present favourable market conditions for licensees will continue. It is also expected that there will be a market correction within three years. Developments further into the future will be largely determined by the economic outlook and the re-insurance market ...
>
> if the insurance market is the preferred solution, then it must be accepted that the market is dynamic and that affordability and availability of [professional indemnity] cover is subject to change. There is a risk that licensees are unable to purchase comprehensive or adequate professional indemnity and that retail clients may not be able to recover their losses against licensees.[2]

3.2 As noted in the report, insurance markets are dynamic and the affordability and availability of professional indemnity cover is subject to change over time. In the market for professional indemnity insurance overall, there is little evidence of a cyclical change in the period since that report. A report by Finity consultants found that average professional indemnity premiums peaked in 2004 and were quite stable until the end of 2008 (the period for which data was available).[3] This trend is supported by available data from APRA's National Claims and Policies Database (NCPD), which is assessed further below.

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1 ASIC Report 107. *Compensation arrangements for financial services licensees – Research into the professional indemnity insurance market*, prepared by Melzan Pty Ltd, December 2006.

2 ibid – at pp 4-5.

3 *Professional Indemnity & Directors' and Officers'– The Market & Challenges*, Finity Consultants, January 2009.

3.3 The professional indemnity insurance market appears to be competitive and affordable overall. However, for providers of certain financial services, particularly financial advice, anecdotal evidence points to a hardening of the professional indemnity insurance market in the last few years. The recent high profile collapses of domestic financial product and service providers, such as Westpoint and Storm Financial, have probably contributed to the tightening in the insurance market for some licensees. It appears that providers of certain financial services, in particular financial advice, are more affected than others.

3.4 In its submission to the PJC Inquiry, ASIC referred to a hardening of the market for financial advisers. ASIC indicated that, in spite of that hardening, its inquiries indicated that the professional indemnity insurance market was still functioning appropriately for licensees overall.[4] Financial advisers were able to acquire cover, albeit at increased premiums.

3.5 In the same submission, ASIC expressed concern that a further hardening of the market was possible in the short term, potentially making it more difficult for some licensees to obtain adequate cover. In the medium to longer term, there was a question whether the market for professional indemnity insurance for financial advisers would return to the level of competitiveness that prevailed when the regulatory requirement commenced.

3.6 It appears that licensees are still able to obtain insurance, but with a trend towards higher premiums for some licensees.

Supply of professional indemnity insurance

3.7 While the precise number is hard to determine, discussions with industry indicate there are at least ten insurers providing professional indemnity insurance for licensees. However, not all underwriters provide cover for a full spectrum of financial services.

3.8 As discussed, there appears to have been a hardening of the professional indemnity insurance market for licensees providing financial advice. It is understood that there are four mainstream underwriters for financial advice, and that at least two insurers have ceased providing cover for financial advisers in recent years. One of the largest providers of professional indemnity insurance in the financial services sector ceased providing cover for financial advisers in 2009.

Demand for professional indemnity insurance

3.9 As noted in Chapter 1, there are close to 5,000 licensed providers of financial services, with around three-quarters authorised to deal with retail clients. ASIC estimates that currently some 3,400 licensees are required to hold professional indemnity insurance.

Access to insurance cover by licensees

3.10 In its submission to the PJC Inquiry, ASIC said that, based on its inquiries, the professional indemnity insurance market was functioning adequately for providers of

4 ASIC submission to PJC Inquiry, August 2009, pp 83-84.

financial services. Licensees were able to obtain cover, but it had become more difficult and expensive for some licensees, including financial advisers, to secure cover that adequately met ASIC's standards.[5] ASIC concluded that licensees, particularly those providing financial advice, faced:

- an increase in premium costs;
- a reduction in policy limits;
  - new policies might have tighter limits on some items, such as for dishonest conduct or an award under an EDR scheme;
- an increase in excluded activities;
  - new policies were unlikely to cover advice on margin lending or for run-off of claims following the end of a policy period (though some licensees are able to negotiate these if they can satisfy the requirements of the insurer);
- an increase in general exclusions;
  - for example, some policies exclude cover for failure by the licensee or its representatives to disclose conflicts of interest in advice documents;
- greater scrutiny of the activities of licensees;
  - insurers may review a licensee's approved product lists and specify those financial products they will or will not cover.

3.11 Licensees and insurance brokers have confirmed these general findings, particularly in relation to cover for financial advisers. A common message to this review from licensees is that they are negotiating with insurers in a less competitive market and it is harder for them to acquire cover that meets ASIC requirements.

3.12 Licensees have expressed concerns about:

- reluctance of insurers to provide the full cover sought by the licensee;
  - where the cover sought is in the upper range indicated by ASIC (say $20 million) the licensee may need to acquire a layered policy from two insurers who share the risk. Licensees are finding it more difficult to find an insurer willing to accept the primary layer of cover;
- difficulty in acquiring a policy that covers all of a licensee's activities;
- the added cost of acquiring cover for defence costs;[6]
  - ASIC requires cover for defence costs in addition to the minimum level of cover, or an increase in the level of cover to take into account those costs. It is said that licensees often meet this requirement by adding the expected cost of

5 ASIC submission to PJC Inquiry, August 2009, pp 82-84.

6 Defence costs are intended to cover legal costs associated with handling a claim. ASIC Report 107 (see footnote 1), suggests that legal costs for a court action were generally between 30-50 per cent of a claim in 2006.

defence to their policy cap, which can be a more expensive way of meeting that requirement.

- difficulty in acquiring cover for EDR scheme awards up to the compensation caps;
  - including to meet the increase in the compensation cap from $150,000 to $280,000 for investment related disputes which takes effect from the commencement of 2012;
- difficulty in acquiring cover for fraud and dishonesty by directors; and
- difficulty in acquiring cover for financial advice relating to particular products on a licensee's approved product list. If an insurer is unwilling to cover particular products due to the risk involved, licensees may be less willing to offer those products.

3.13 While the concerns flagged by licensees do not mean that they are ultimately unable to obtain cover, changes in the terms called for by ASIC may require further negotiation with insurers.

Cost of professional indemnity insurance

3.14 APRA collects data from insurers on premiums and claims for professional indemnity insurance. The data in Table 3.1 for financial occupations relates to an aggregated group which includes accountants and others who do not necessarily require a licence.

Table 3.1: Average written premiums for PII by underwriting year ($)[(a)]

Occupation	2005	2006	2007	2008	2009
Financial occupations(b)	8,922	7,681	6,874	6,300	6,459
All occupations(c)	4,106	3,430	3,152	3,071	2,829

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
(c) All occupations, including the financial occupations shown separately.
Source: APRA National Claims and Policies Database (NCPD).

3.15 Average professional indemnity insurance premiums for financial occupations have decreased since 2005, and have remained fairly stable from 2007 to 2009. Premiums for financial occupations are consistently more than twice as high as premiums for all occupations as a group. This could reflect higher levels of cover, as well as insurers' views on the risk associated with this group of policyholders.

3.16 Owing to limited available data, it is difficult to identify trends in premiums for specific occupations and sub-sectors of the financial services industry. However, licensees and insurance brokers have referred to an upward trend in premiums, with increases differing significantly according to the activities of the licensee. Insurance brokers have indicated that their own premiums have remained relatively stable in recent years. On the other hand, financial advisers and property fund managers appear to have experienced larger cost increases, with examples of annual premium increases up to 30 per cent. ASIC's submission to the PJC Inquiry also stated that financial advisers faced increased premiums.[7] Some licensees have said that professional indemnity insurance is becoming a relatively larger operating expense

7 ASIC submission to PJC Inquiry, August 2009, pp 82-84.

for their business. The experience of financial advisers appears to belie the position indicated by the aggregate APRA data which includes non-AFSL holders and 'financial occupations' other than financial advisers

3.17 Cost pressures for professional indemnity insurance may create an incentive for licensees to trade off some of their premium cost for a higher excess. A licensee who reduces its business costs by making this trade off would increase its financial exposure to future claims for compensation.

3.18 In its regulatory guidance, ASIC addresses the trade-off between the amount of excess under a policy and the cost of premiums and makes it clear it is the responsibility of the licensee to consider how they will cover the insurance excess if a claim is made. They are required to assess the financial resources required (to cover the excess and gaps in cover due to various exclusions) and to ensure they have such financial resources available. ASIC says that a licensee should be able to demonstrate to itself, as well as to ASIC, if necessary, that it has financial resources available to cover the excess and gaps in cover due to exclusions.[8]

Trends in insurance claims

3.19 Due to confidentiality provisions, publicly available data on professional indemnity insurance claims is limited. However, the Insurance Council of Australia (ICA) says there has been a significant increase in claims paid to financial advisers. It provided the following statement to the review:

> Data made available to the Insurance Council by its Members shows that professional indemnity insurance claims paid in relation to financial planners have climbed significantly over the past five years, increasing around fourfold. The data typically has a time lag between claims paid spikes and financial collapses. It can be expected with recent collapses such as Storm and the fallout of the GFC that the steeply upward trend of professional indemnity insurance claims paid will continue.

3.20 The ICA added that:

> The data demonstrates the significant role that professional indemnity insurance plays in ensuring that money is available to pay compensation for most breaches of the financial services law.

The upward trend in claims described by the ICA is supported by APRA data. Table 3.2 shows gross claims incurred for financial occupations according to the year in which the loss occurred. For example, a claim lodged in 2009 in respect of a breach, such as inappropriate advice, that occurred in 2007 would be recorded in the 2007 accident year. For some policies, the date of the loss may be recorded by insurers as the date that the claim was notified to the insurer.

3.21 Due to the nature of financial services, it may take several years for a breach to be identified and for a claim to be made. It follows that claims figures recorded for more recent accident years may understate the emerging experience. Table 3.2 shows a large spike in claims due to events that occurred in 2008. This may reflect the onset of the global financial crisis and collapses of various financial service and product providers.

8 ASIC RG 126, paras 47-49.

Table 3.2: Gross claims incurred for PII (by accident year) by occupation ($ million)[a]

	2005	2006	2007	2008	2009
Financial Occupations(b)	53.5	72.3	59.7	176.4	63.8

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA's NCPD.

3.22 Table 3.3 shows gross claims incurred for financial occupations according to the year the claim was paid, or that a change was made to the provision for a claim on the books of the insurer. These claims may relate to events and claims that date back some years and have taken time to settle.

Table 3.3: Gross claims incurred for PII (by calendar year) by occupation ($ million)[a]

	2005	2006	2007	2008	2009
Financial occupations(b)	26.3	58.9	67.8	77.3	224.1

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA NCPD.

3.23 Table 3.3 indicates a significant increase in claims incurred from the 2005 calendar year onwards and a very large jump (almost 300 per cent) in claims incurred from 2008 to 2009. This is likely to reflect the significant rise in claims incurred due to events that occurred in the 2008 accident year (shown in Table 3.2). It should be noted that data from the 2005 and 2006 calendar years have incomplete occupation information, some of which would have related to financial occupations.

3.24 Table 3.4 shows total professional indemnity insurance premiums written for financial occupations by underwriting year. A comparison of Table 3.4 with Table 3.3 shows that the value of claims incurred in 2009 was $224 million while the total amount of premiums written for the 2009 underwriting year was $178 million. One potential outcome of the disparity between these figures could be a flow-on impact on insurance premiums.

Table 3.4: Gross written premiums for PII by occupation and underwriting year ($ million)[(a)]

	2005	2006	2007	2008	2009
Financial occupations(b)	163.3	155.0	161.3	171.2	178.2

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA NCPD.

Insurance as a means of compensation

Benefits of professional indemnity insurance

3.25 It seems clear that professional indemnity insurance plays a large part in assisting licensees to compensate complainants. It provides a measure of assurance that a claim will be met. The insurance mechanism serves this purpose to the extent that claims are covered by the terms of a licensee's policy. However, as discussed below, this will not always be the case and there are also circumstances in which no policy will be in place to respond to a claim.

3.26 The use of a commercial insurance product as the basis for compensation may have an indirect benefit so far as insurers play a role in assessing the risk worthiness of licensees. Insurers typically have regard to a range of criteria in determining their underwriting risk, including a licensee's risk management processes and controls, the professional training of staff and audit processes, and the licensee's compliance record. Weaknesses may be identified through this process. Cover for high risk products may be declined, thereby encouraging the licensee to avoid such products.

3.27 In this way, the annual process of policy renewal provides an indirect check of the operating systems of licensees. A licensee who is unable to satisfy an insurer's process in order to obtain or renew cover, and who cannot obtain adequate cover from another insurer, is required to file a breach report with ASIC. A breach report will act as a red flag for ASIC and should attract attention and scrutiny of the licensee in question.

Limitations of professional indemnity insurance

3.28 There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer a loss as a result of a licensee's misconduct. As stated in RG 126, ASIC intends to administer the professional indemnity insurance framework to reduce the risk, as far as possible, that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients.[9] However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers.

3.29 In evidence to the PJC Inquiry, ICA noted that it is problematic to try to make a commercial product into a compensation mechanism.[10] ASIC is also of the view that

9 ASIC RG 126, p 4.
10 Ripoll Report, p 92.

there are inherent limitations on the effectiveness of professional indemnity insurance as a compensation mechanism for retail investors who suffer loss.[11]

3.30 The obligation to meet a successful compensation claim rests with the licensee in question. If, for whatever reason, the licensee's professional indemnity insurance policy does not respond to such a claim, the licensee is left to meet the liability from its own resources.

3.31 The gap in the current compensation arrangements arises where an insurance policy does not respond to a claim and the licensee is not otherwise in a position to meet the liability.

3.32 The PJC Inquiry received a substantial amount of evidence on compensation arrangements for retail investors, with a particular focus on the shortcomings of professional indemnity insurance. The Ripoll Report notes that:

> ... professional indemnity insurance is not intended to be a catch-all scheme designed to compensate investors whenever they have a successful claim against an adviser. It merely ensures that advisers can meet their obligations if a finding is made against them, if occurring in circumstances covered by the relevant insurance policy. Investors are not protected in a number of important situations, notably where the licensee has become insolvent, disappeared or behaved fraudulently ...

3.33 There are many reasons why a professional indemnity policy may not respond to a claim.

3.34 Some of the limitations flow from the 'long tail' nature of liabilities associated with providing financial services, combined with the 'claims made' basis of professional indemnity insurance policies. 'Long-tail' liability means that claims may be notified several years after the service is provided or the breach occurs. According to APRA, for professional indemnity 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.[12]

3.35 Where a claim is made after a policy expires, it will not be considered under the policy unless the policyholder has run-off cover. Given the difficulties many licensees face in obtaining run-off cover, this presents a particular problem for claims made after a licensee ceases to trade. By the time a loss is identified and a claim lodged, there may no longer be a policy in force to respond to the claim.

3.36 The limitations of professional indemnity insurance, and circumstances whereby a policy may not react to a claim, are described further below including where:

- there is no run-off cover available and the licensee has ceased to operate;
- the licensee becomes insolvent and the policy is subsequently cancelled;
- a licensee is in breach of its contractual obligations under the policy;
- the claim falls within an exclusion in the policy;

11 ASIC submission to PJC Inquiry, August 2009, p 83.
12 ASIC Report 107 p 23.

- a licensee faces multiple or large excess payments; and
- the claim exceeds a cap on the cover provided by the policy.

Run-off cover

3.37 Run-off cover provides cover for claims made after an insurance policy has ended with respect to loss or damage arising earlier while the policy was in place. As run-off cover is not generally available to licensees, it follows that professional indemnity insurance is of limited value in underpinning the payment of compensation claims after an insurance policy has ended.

3.38 In the absence of run-off cover, claims arising from events occurring during a period where the insurance policy was in place, but not made until after that policy has ended, will not be covered. It follows that a licensee who retires, or otherwise exits the market, may be exposed to claims without recourse to insurance cover. This increases the risk for claimants of not being able to recover compensation awarded to them.

3.39 As discussed in Chapter 2, ASIC proposed earlier to require licensees to hold run-off cover for a period of at least one year. However, ASIC found the insurance market was generally unwilling to provide run-off cover for financial services providers, and did not proceed with the proposed requirement.

3.40 It is noted that individual licensees may be able to secure run-off cover in some circumstances on the basis of their insurance history or other circumstances. Some professional bodies in the financial services sector have been able to secure run-off cover through master policies which are available to their members. Run-off cover, where it is available, can be relatively expensive.

3.41 Given the absence of generally available run-off cover, it is relevant to note that a significant number of licensees cease to carry on business each year. Table 3.5 shows the number of licences that have been cancelled, voluntarily or by ASIC, over the past five years.

Table 3.5: Australian Financial Services Licence cancellations

	2005 -2006	2006-2007	2007-2008	2008-2009	2009-2010
Voluntary cancellations	152	141	168	227	250
ASIC initiated cancellations	0	5	20	22	19

Source: ASIC database

Insolvency leading to cancellation of an insurance policy

3.42 ASIC and FOS have drawn attention to the limitations of professional indemnity insurance as a compensation mechanism in situations where a licensee becomes insolvent.

3.43 Some of the difficulties relate to the timing of a claim following insolvency. Where a claim is made while the licensee’s insurance policy is in force, the claim can be dealt with even if the licensee has become insolvent. However, where the claim is made after the licensee’s insurance policy has lapsed or been cancelled, the policy will not respond.

3.44 The settlement of an insurance claim after a licensee becomes insolvent is likely to involve the liquidator of the licensee's business. The liquidator may pay any excess provided under the policy in order to facilitate the claim and then pass on the amount recovered to the claimant net of the excess, or the insurance company may make a payment (net of the excess) to the claimant direct.[13]

3.45 A licensee will generally be required to notify its insurer if it becomes insolvent, and in many cases an insurer who is so notified will cancel the policy with effect within seven to thirty days. An insurance contract cannot be cancelled retrospectively, and any claims made prior to cancellation have to be dealt with under the policy.

3.46 In any event, the liquidator of an insolvent licensee may well discontinue the licensee's insurance policy on the basis that further premium payments would only be for the benefit of certain claimants.

3.47 Where a claim is made in circumstances where a licensee has become insolvent and professional indemnity insurance policy is no longer in force, the claimant will only have rights as an unsecured creditor in the winding up of the licensee's business. A claimant is unlikely in those circumstances to recover all, if any, of the compensation to which it may be entitled.

Breach of insurance contract

3.48 An insured party normally has a number of obligations under an insurance contract such as to inform the insurer about a claim or loss as soon as possible, and to take reasonable steps to lessen liability in relation to a claim.

3.49 If a licensee fails to meet such an obligation, the insurer may be entitled to deny payment of a claim.[14] Further, an insurer who can demonstrate that the breach has a material impact on the risk associated with the policy may be entitled to cancel the contract.[15] Non-payment of claims or cancellation of a contract can lead to protracted disputes between the licensee and insurer and any delay could add to the financial pressure on a licensee.

Caps in insurance contracts

3.50 Professional indemnity insurance contracts generally provide cover up to a capped amount. As stated in RG 126, ASIC considers that, to be adequate, a licensee's professional indemnity insurance policy should have a limit of at least $2 million and up to $20 million, depending on the total revenue the licensee derives from retail clients.[16]

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13 Section 562 provides that the proceeds of an insurance contract should be paid to the third party that has incurred the liability in priority to the payments of the company's debt (though there may be exceptions).

14 Section 54 of the *Insurance Contracts Act 1984* provides that the insurer is not automatically entitled to deny payment of a claim in the case of breach of a contract. In the case of relatively minor breaches, the insurer may be entitled to reduce the insurance payout to the extent the breach of contract had a material impact on the claim.

15 Cancellation of insurance contracts is dealt with in Part 7 of the *Insurance Contracts Act 1984.*

16 ASIC RG 126, p 24.

3.51 ASIC also calls for a policy to include at least one automatic reinstatement.[17] ASIC believes that automatic reinstatement is generally available in the market, but acknowledges that it may come at a higher cost than for prior premiums.

3.52 Where a licensee is faced with a large number of claims, or several large claims, the amount awarded to claimants in aggregate may exceed the capped amount of its cover. To the extent that the claims exceed the cover provided by its insurance policy, the licensee will have to meet them from its own financial resources if reinstatement is not available.

Excess payments

It is common for insurance policies to require the policy holder to bear an excess or deductible amount when a claim is made. To the extent that an excess or deductible is payable, the licensee is self-insuring. The larger the excess or deductible, the more financial pressure a licensee may come under when faced with a claim. Where a licensee is faced with a large number of claims, this pressure will be exacerbated.

Policy exclusions

3.53 Professional indemnity insurance contracts commonly include a number of exclusions or circumstances under which the policy will not cover a claim. For example, some insurers will not cover certain products on a licensee's approved product list (APL).[18] The excluded products may be higher risk or more complex products. Losses arising from the fraudulent or dishonest conduct of a licensee are also typically excluded. Where a claim falls within a policy exclusion, the insurance contract will not respond and the licensee will have to meet the claim from its own resources.

Consequences where insurance not available

3.54 As indicated above, there are various circumstances in which a licensee will not be able to claim against a professional indemnity policy, or claim the full amount, in order to meet its liability to a retail client. In those circumstances, the licensee remains liable to meet that claim from its own resources.

3.55 The claimant is then exposed to the risk that the licensee will not be in a position to meet the claim owing to the closure of its business, insolvency or other reason. Where the licensee has become insolvent in the absence of insurance, the claimant's only avenue for compensation is through the liquidation process. As an unsecured creditor the claimant is unlikely to recover all, if any, of its claim.

3.56 The essence of the problem for a claimant, where a licensee is not able to look to an insurer to cover a claim, is that the licensee may be insolvent (or become insolvent as a result of claims against it), is no longer trading or in a position to provide compensation.

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17 Automatic reinstatement 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 period to cover any new claims that might arise.

18 An APL is a list of financial products which a licensee is comfortable recommending to clients. Licensees would typically perform due diligence and research when determining whether a product will be included on their APL. Many though not all licensees use an APL, and some licensees only permit their authorised representatives to recommend products that are on the approved list.

Inability of retail clients to recover compensation

3.57 It seems clear that cases do arise where retail clients are unable in practice to recover compensation awarded in their favour. However, it is not easy to gauge the magnitude of the problem. Information provided by ASIC and FOS sheds some light on the problem but precise data is limited. For example, it may not capture the outcome of all claims, such as where they are settled, or fully reflect instances where claims are not pursued owing to the limited prospect of recovering any award made against the licensee.

3.58 Part of the problem lies in distinguishing between investment losses, such as may follow the collapse of a product provider, and losses that can be attributed to a financial services provider breaching its legal obligations, for example by providing inappropriate advice.

3.59 It should be noted too that it is not clear from the available information whether, in the cases where retail clients are unable to recover compensation to which they are entitled, the licensees had in fact taken out and maintained insurance cover as required, or whether such cover had lapsed following the winding up of the licensee's business or was still in force but did not respond to the claim.

3.60 FOS has provided some information about cases in which clients were not able to receive compensation where one of its members became insolvent. The data covers 78 claims for compensation which involved members (licensees) at the point of insolvency in the five years to December 2009.[19] In aggregate, a total of almost $4.6 million was awarded in compensation, but claimants only recovered $2.7 million of that amount.

3.61 Further information provided by FOS indicates that in the period September 2007 to September 2010, it handled 69 complaints where the member became insolvent. Table 3.6 shows the outcomes of those claims. In almost 60 per cent of cases, the claim was withdrawn by the complainant.

Table 3.6: Outcome of complaints to FOS against insolvent financial advisers

Outcome	Number of Claims
Withdrawn by complainant	41
Found in favour of complainant	10
Found in favour of member	4
Yet to be finalised	3
Resolved by member without FOS involvement	2
Outside jurisdiction	9
Total	**69**

Source: FOS.

FOS is aware that, in at least 6 of the10 cases where it found in favour of the complainant client, the complainant received no payment of compensation. In at least two of these cases, the reason for non-payment of compensation was lack of funds available for unsecured creditors and lack of available professional indemnity insurance.

19 FOS says this data is not exhaustive of all cases involving insolvent licensees during this period and it is likely there were other cases involving insolvent licensees.

3.62 FOS believes that the figures are likely to under-represent the number of claims relating to insolvent licensees. This is because many claims, or initial approaches to FOS, are withdrawn by the complainant or not pursued once the licensee becomes insolvent as the complainant considers the chances of recovery to be low.

3.63 Other clients with grievances against an insolvent licensee (or a licensee on the verge of insolvency) may not take their complaint to an EDR scheme for the same reason.

3.64 Apart from the aggregate FOS data referred to above, reference has been made to some specific cases, discussed below, where claimants have been unable to recover compensation that has been awarded to them.

Westpoint

3.65 In early 2006, the Federal Court ordered the winding up of Westpoint Corporation Pty Ltd (Westpoint) following an application by ASIC on the grounds of insolvency. Investors had outstanding capital of $388 million invested in Westpoint financial products at that time.

3.66 Westpoint's difficulties related to a number of projects for which part of the funding was raised through the issue of promissory notes, a form of debenture, to retail investors. Retail clients generally made their investments in a Westpoint financial product following advice from a financial adviser. Retail clients have claimed losses, at least in part, because of the poor or misleading advice received. ASIC has brought successful actions against seven financial adviser groups as well as other parties. These actions involved the use of ASIC's section 50 powers on behalf of investors.[20] It is noted that Westpoint was found in the legal proceedings to have been operating an unregistered managed investment scheme and had not held a license.

3.67 Table 3.7 provides some information about ASIC's actions against financial advice groups in relation to Westpoint.

20 For a description of these powers see para 2.35.

Table 3.7: Compensation recovered by Westpoint investors as a result of ASIC action

Defendant Financial service provider	Subsequent insolvency of the business	Investors for whom ASIC sort compensation	Total damages claimed	Amount determined through settlements
Masu Financial Management Pty Ltd	No	85 (25 other investors took separate legal proceedings).	$12.6 million	Settlement details not disclosed
Professional Investment Services Pty Ltd (PIS)	No	247	$22.8 million	$5.9 million
Bongiorno Financial Advisers Pty Ltd/Bongiorno Financial Advisers (Aust) Ltd	Bongiorno Financial Advisers (Aust) Pty Ltd is no longer licensed. Bongiorno Financial Advisers Pty Ltd is currently licensed.	125	$8.5 million	$2.6 million
Glenhurst Corporation Pty Ltd	Yes	90	$7.1 million	$2.5 million
Brighton Hall Securities Pty Ltd	Yes	200	$14 million	Not yet resolved
Dukes Financial Services Pty Ltd (now known as Barzan Pty Ltd)	No	159	$12.2 million	$1 million
Strategic Joint Partners Pty Ltd	No	80	$6.5 million	Not yet resolved

Source: ASIC FIDO and Westpoint investor website pages

3.68 Drawing from data in Table 3.7, for cases where the settlement amount is publicly known, the average claim against adviser groups was approximately $81,000 and the average settlement amount was approximately $19,000 per investor.

3.69 As far as ASIC is aware, all amounts of compensation agreed in settlements in Table 3.7 have been paid, or will be paid, to affected clients. In the case of Glenhurst Corporation Pty Ltd, the settlement was reached with its professional indemnity insurer. It should be noted that Westpoint investors who benefited from the settlements in Table 3.7 may also have benefited from other ASIC actions and FOS determinations described below.

3.70 ASIC has pursued, or is in the process of pursuing other actions against auditors, directors, and a trustee in relation to Westpoint. On 1 February 2011, ASIC announced it had reached agreements to settle the actions it brought against certain directors and the former auditors of Westpoint.[21] Those settlements will result in the recovery for the benefit of investors through the liquidation process of up to an additional $67.45 million. Overall, over the five years since the company collapsed, investors in Westpoint have recovered an average of approximately 43 cents for each dollar invested.

3.71 Separate from the actions pursued by ASIC, according to a report prepared by Professional Financial Solutions Pty Limited (PFS) over 400 Westpoint investors pursued complaints against licensees, largely adviser groups, through FOS over the period 1 January 2006 to 30 June 2008. Of these claimants, 37 had awards made in their favour by FOS but did not receive any compensation because of the insolvency of the respondent licensee. The unpaid amount was in the order of $2.4 million.[22]

21 *ASIC settles Westpoint compensation litigation,* ASIC media release 11-17, 1 February 2011.

22 *Proposal to Establish a Financial Services Compensation Scheme*, prepared by Professional Financial Solutions Pty Limited for Financial Ombudsman Service, October 2009.

Further claims made to FOS were deemed to be outside its jurisdiction. It should be noted that the cases in which claimants did not receive any compensation because of insolvency may also be referred to in the FOS cases referred to in paragraph 3.59.

3.72 FOS has informed the review that any apparent inconsistency between the number of Westpoint awards described in the PFS report and the data in Table 3.6 is due to the timing of the determination of those cases. FOS says many Westpoint cases were determined before September 2007.

3.73 In addition to the data in the PFS report, FOS has provided information about some further cases involving Westpoint investors determined since that time in which claimants did not receive full payment of amounts awarded to them. In nine separate cases, a total amount of $540,000 was awarded to complainants. As far as FOS is aware, in four of those nine awards, no compensation was received by the complainant. In the remaining five awards, the claimants recovered something through the liquidation process, but less than the amounts awarded to them. For all Westpoint cases it has considered to date, FOS indicates it has awarded a total of $8.5 million to complainants. Therefore, combining the available data on unpaid awards, it appears that somewhere in the vicinity of 30 per cent of the total amount awarded by FOS has not been paid.

Storm Financial

3.74 Another collapse of a financial services provider causing large scale loss to retail clients was Storm Financial (Storm) which had approximately 14,000 clients, about 3,000 of whom held margin loans for share market investments. Storm went into administration in December 2009 after receiving notice from the Commonwealth Bank of Australia (CBA) to repay its corporate debt facilities within 24 hours.

3.75 ASIC is currently investigating a range of issues relating to Storm and its collapse, including investments in home lending and margin lending as well as related advice. These investigations formally began on 12 December 2008 and are ongoing.[23]

3.76 ASIC has begun penalty proceedings against the directors of Storm, and has also decided to commence compensation proceedings against the CBA, Bank of Queensland Limited and Macquarie Bank Limited on behalf of Storm investors. There are also lawsuits brought by law firms on behalf of Storm investors.

3.77 It is not yet clear whether ASIC will bring actions relating to inappropriate advice or other breaches of Chapter 7of the Act, or the extent to which claims by retail investors relate to such breaches. It also remains to be seen whether any compensation which may be awarded to affected investors in respect of such breaches will ultimately be recovered by them.

Other corporate collapses

3.78 According to ASIC and FOS, a handful of small and medium sized licensees are generally wound up each year with outstanding claims against them by retail clients. ASIC says that such a case might involve a licensee with a number of outstanding claims amounting to several million dollars.

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23 ASIC Storm Investor website including AD08-09 of 24 December 2008.

3.79 As already noted, the ability of the claimant to recover compensation in such cases will depend on the licensee's available financial resources or its success in claiming under its professional indemnity policy.

3.80 FOS has referred by way of example to a recent case in which approximately $1.2 million has been awarded in favour of complainants, with an average award of about $91,000. None of the awarded amount has been received by complainants at this time. FOS is still to consider further claims against the same licensee amounting to approximately $2.9 million.

Issues of interest

Premium and payout experience

Information and comment are sought on trends in premiums for professional indemnity insurance borne by licensees, and on claims experience under those policies, from 2008 when the requirement for professional indemnity insurance was applied broadly to licensees. In particular, the following aspects are of interest:

3.1 The trend in premiums for professional indemnity insurance taken out by financial services licensees, and the factors behind that trend.

3.2 The trend in claims paid under professional indemnity insurance held by those licensees and the value of claims made under those policies which are still outstanding.

3.3 As a subset of the above, the proportion of the premiums received from, and claims paid out to, licensees who provide financial advice.

3.4 The typical grounds upon which claims under professional indemnity insurance policies are not met.

Experience with compensation arrangements

Comment and perspectives are sought on the effectiveness of current compensation arrangements, including the costs and benefits for consumers and industry of the reliance on professional indemnity insurance as the default arrangement for compensation. In particular, the following aspects are of interest:

3.5 The costs and benefits of professional indemnity insurance for licensees and the financial services industry more broadly.

3.6 The level of assurance to retail clients that claims for loss or damage will be dealt with and awards for compensation paid.

3.7 The contribution of the current compensation arrangements in maintaining confidence by retail clients in dealing with financial services providers, including financial advisers, and in underpinning responsible behaviour by licensees.