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One down, one to go

The PI insurance pricing crisis may be over, but a new breakdown looms

Eighteen months ago, the Financial Planning Association (FPA) declared that its members faced steep rises in professional indemnity (PI) insurance premiums, with more than half having trouble securing cover. Worse was the fact that members were being exposed to an increased level of commercial risk due to more policy exclusion clauses. Has anything changed?

“The PI pricing crisis is over, but the new PI crisis has begun,” says Peter Kalantzis, former employee of the FPA and now a professional indemnity insurance consultant for the financial services industry. “Increased competition has brought down professional indemnity insurance premiums but surprisingly for an industry that prides itself on the know-your-client and know-your-product rules, there is still a major gap of understanding when it comes to PI insurance and risks”.

There is a looming crisis in PI insurance, promoted not only by squeezing margins and competition but fuelled by industry ignorance and apathy. It will be a quiet and private crisis borne by those who discover too late how they should have taken up PI insurance.

The Financial Wisdom case, where a licensee was found liable for advice given by its representatives, is a relevant example. It is not about the blame that Financial Wisdom should bear, since it was not part of the failings that cost the clients their life savings. The real issue is whether the clients can pin the failings of another (who does not have money or adequate PI insurance) on Financial Wisdom that, much to its regret, endorsed the negligent advisers.

The Government continues to have a problem with determining the adequate compensation requirements of financial services reform. Almost three and a half years after introduction, we still do not have any regulations as foreshadowed by section 912B of the Corporations Act. It remains up to ASIC to work it out on a licensee-by-licensee basis. So does everyone need to have PI insurance? I don't know, only ASIC does.

The new PI crisis is avoidable, if only the industry does for itself what it demands that it should do for its clients. The know-your-client rule requires the financial services industry to consider the ambitions, resources and risks of clients when formulating a financial plan. Many extend this concept into a know-your-product rule, to ensure that each financial plan is supported by the right financial product. So why has this most fundamental financial services approach been ignored by the industry when it comes to its own professional indemnity insurance?

There is a clear lack of understanding of professional indemnity insurance. It is more than just a FPA membership requirement. It goes well beyond a licence condition. PI insurance must be viewed as part of the compliance and risk management programme of the financial planning business.

Most licensees and advisers have not even read the terms of their PI cover. That is like a courier buying a truck and not knowing how (or even if) the brakes work. Of the few who have read their policy, many have found to their delight that their PI insurer will agree to changes that increase the protection they have bought. However, almost no one has adjusted their business systems to reflect the context of protection that their PI policies provide.

Jason Grant, the Australasian underwriting manager for the Financial Lines products of American Home Assurance Group, has been heard to say that “payment of a claim is what we do, it is important to us to pay PI claims, otherwise if there were no risks there would be no market for our services. Obviously, it is up to us to ensure that we get our claim-to-premium management right — that is how we can afford to be in this business.”

It is a fact that seems to be lost on some in the financial services industry that PI insurance is legal gambling. The insurance company accepts your premium and bets that you will not have a claim, or that the total of all claims will be less than the total of all premium bets. The business of PI insurance is the simple difference between collecting premiums and limiting claims. The more successfully an insurer can do this, the more profitable it will be. So when premiums come down, one of only two things can be occurring: either insurer profits are falling or policy exclusions are widening with the intent that the policy will not respond to as many claims.

Any PI contract purchased based only on price is commercially insane and doomed to one day fail, which is when the rest of the industry will be needed to pick up the pieces, just like Financial Wisdom is now being asked to do. The starting point for any PI insurance selection is to know the client, that is, to know yourself. What is the nature of your business? How do you wish to practice?

Start by asking for policy terms, not premium quotes. Invest half a day in researching how to make the professional indemnity insurance policy fit your business. Hopefully it will be wasted time, and you will never face a claim. But just in case, to help you in your assessment of PI, use the following checklist.

Can you afford the deductible? This is not just a question of whether you can afford to pay the first \$5000, \$25,000 or \$100,000.



The question is, can you afford the multiple deductible obligations. If you have similar clients or similar ways of doing business, when an error occurs it will apply to many clients, and as a result there will be multiple professional indemnity insurance claims. Under your policy, will this be treated as one claim with only one deductible payable by you or will it represent multiple claims, each with its own deductible?

Does your policy exclude family members? Or does it exclude family member claims that are assisted by the adviser? To know is to understand how to set your policies. If family members are excluded, do you have a policy that excludes advising family members? Perhaps the adviser indemnity in the authorised representative agreement needs to be more robust. At a minimum, monitoring and supervision must be the rule with family member files.

Do you have the right to choose your lawyer or are you left with the insurer's lawyer? And who has the right to settle a claim? Some insurers will allow you to manage the defence even when they want to settle. This is important when you know that the claim is baseless. Others will not allow you this right, and if they settle then you do as well. AMP was more than a little miffed by the management of the professional negligence claim against it when, after believing they had an agreement, it later discovered their management of the claim was accepted by a court as part of the reason why the insurer could escape the indemnity.

A common exclusion involves any financial investment or product not on the approved product list. Therefore, client directed investments carry greater risk. Have you adjusted your disclosure systems to cover the risks or are you unknowingly self-insuring? Conflict of interests, actual or alleged, can also be excluded, unless

the conflict has been properly managed. So does your monitoring and supervision do this? Geared investments are a common exclusion. It is also common for insurers to amend this provided they are satisfied that good risk management systems are in place. Another common exclusion is any claim the tax office says is related to Part IVA of the Income Tax Assessment Act. This is a real worry, the tax office always claims Part IVA when threatening client taxpayers.

The Financial Industry Complaints Service (FICS) limits are well known, and many policies limit the indemnity as well. Cover of \$100,000 is enough for an investment claim, but not if the limit is \$200,000 in the aggregate. And it is not enough for a life insurance FICS complaint, which can be up to \$250,000.

When changing policies, make sure that you over-compensate on the disclosures. Just ask poor Mr Tigals, a tax agent who was sued by his client. When changing insurers, he did not go overboard on his disclosures of possible risks. His insurer used this to later avoid liability under the professional indemnity policy. Have you changed insurers recently? You may have a great contract but were your disclosures up to standard?

The existence of professional indemnity insurance is not a solution, it is merely part of the programme of risk management. The first and most effective risk management tool is professionalism. This is why organisations should sack their compliance personnel and only employ professional standards officers. Having a culture of compliance is wrong — a culture of professionalism should be the goal.

PI insurance is there to protect. But it cannot help you unless you know how it works and you embrace it properly. I hope that you do — confidence in the industry relies on it.

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