



FINANCIAL PLANNING
ASSOCIATION of AUSTRALIA

Ms Kate Carnell
The Ombudsman
Australian Small Business and Family Enterprise Ombudsman
GPO Box 1791
CANBERRA ACT 2601

Email: inquiries@asbfeo.gov.au

28 August 2020

Dear Ms Carnell

Insurance Inquiry

The Financial Planning Association of Australia (FPA) welcomes the opportunity to provide input into the Australian Small Business and Family Enterprise Ombudsman's Insurance Inquiry.

The FPA's submission focuses on issues impacting small financial planning businesses accessing adequate and affordable professional indemnity insurance as required under the Corporations Act 2001.

The FPA would welcome the opportunity to discuss with the ASBFEO the issues raised in our submission. Please contact me on [REDACTED] or [REDACTED] if you have any questions.

Yours sincerely

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Head of Policy, Strategy and Innovation
Financial Planning Association of Australia¹

¹ The Financial Planning Association (FPA) has more than 14,000 members and affiliates of whom 11,000 are practising financial planners and 5,720 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally.

- Our first "policy pillar" is to act in the public interest at all times.
- In 2009 we announced a remuneration policy banning all commissions and conflicted remuneration on investments and superannuation for our members – years ahead of FOFA.
- We have an independent Conduct Review Commission, chaired by Dale Boucher, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 26 member countries and the more than 175,570 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 18 Australian Universities for degrees in financial planning. Since 1st July 2013 all new members of the FPA have been required to hold, or be working towards, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally.
- We are recognised as a professional body by the Tax Practitioners Board.



FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

ASBFEO INSURANCE INQUIRY

Prepared for the Australian Small Business and Family Enterprise Ombudsman

26 August 2020

Overview of the financial advice profession

To understand the practices of the insurance industry impacting small financial planning businesses and whether insurance products are fit for the purposes of small financial planning business, the structure of the financial advice market and licensing regime must be considered.

Regulatory overview of financial advice

A financial planner (also known as a financial adviser) is a person or authorised representative of an organisation licensed by ASIC to provide personal financial advice.

Financial advice is regulated under the Corporations Act 2001 (Cth) as 'financial product advice'. A financial planner must either hold an Australian Financial Services Licence (AFSL) or provide financial advice as a representative of an AFSL holder (a licensee).

A financial planner is often referred to as a 'representative'. A 'representative' of an AFS licensee is:

- An 'authorised representative' of the licensee;
- An employee or director of the licensee;
- An employee or director of a related body corporate of the licensee.

AFSL holders are subject to general licensee obligations, conduct and disclosure obligations as well as additional obligations for providers of financial product advice to retail clients. There are also some obligations that apply directly to representatives.

Financial planning is also regulated under the Tax Agent Services Act 2010 as a tax (financial) advice service. A tax (financial) adviser must be registered directly with the Tax Practitioners Board (TPB) or an individual must operate within a registered business under the supervision of an individually registered tax (financial) adviser.

The financial planning profession is highly regulated. In the near future one piece of personal financial advice will be regulated by 9 regulators - ASIC, TPB, AUSTRAC, Office of the Australian Information Commissioner (Privacy), APRA, ATO, FASEA, the ACCC (under the consumer data rights framework) and the new statutory financial adviser disciplinary body[1] - all administering Acts and regulatory requirements imposing different compliance requirements on financial planners. In addition, the same piece of advice will have oversight and interpretation by the Courts, the Australian Financial Complaints Authority (AFCA), Australian financial service licensees and professional bodies such as the Financial Planning Association.

Market overview

The personal financial advice market consists of approximately 2,155 licensees and 21,743 financial planners registered on the ASIC Financial Adviser Register (FAR).[2]

The structure of the advice market is unique - it has a large number of small businesses who hold and operate under their own AFSL, however there is also a large number of small business financial planning practices that are authorised and operate under the AFSL of a large dealer group. Such dealer groups may also have employed advisers.

The following information on the concentration of the Australian financial planning industry shows the high proportion of small licensees operating financial planning businesses and changes in the market over the past three years.

| | October 2017[3] | August 2020[4] |
|--|-----------------|----------------|
| Percentage of advisers (both aligned and non-aligned) operating under a licence controlled by the largest 10 financial institutions; | 44% | 35% |
| Percentage of total (including aligned and nonaligned) advisers operating under a licence controlled by 6 financial institutions – the four major banks, AMP and IOOF Holdings | over 35% | 21% |
| Percentage of the total number of financial advisers on ASIC's Financial Advisers Register who work for one of the major banks | 30% | 7% |
| Percentage of advice licensees operating a firm with less than 10 financial advisers. | 78% | 89% |
| Percentage of advice licensees with less than 50 advisers, | 90% | 96% |
| Percentage of advice licensees with less than 100 financial advisers. | 95% | 98% |
| Average number of financial advisers operating under an AFS licence | 34 individuals. | 20 individuals |

Business models

The licensing regime has led to the development of a variety of business models in the advice profession.

Dealer groups

Financial planners can operate in advice groups (also known as dealer groups or licensees). Under this structure, a corporate entity in the group will hold an AFSL, permitting the financial planners who are members of the advice group to operate as its authorised representatives and provide financial advice to consumers on its behalf.

Such financial planners provide financial advice to consumers under both the AFSL and the commercial brand of the dealer group and/or their own business trading name. In return, dealer groups provide their members centralised back office services and support.

Aligned/non-aligned

Financial planners (and dealer groups) can be classified as either being independent, non-aligned, or aligned with a financial institution, such as a bank, financial product provider, or a wealth management services provider.

For aligned financial planners, the alignment can occur in various ways, including via vertical ownership structures, contractual relationships, and permitted benefits.

Business model examples

- Large licensees will have multiple (some as many as 60 or more) practices (small businesses) located across Australia operating under one licence; some large licensees have both employed planners and corporate authorised representatives operating under their licence.
- Corporate authorised representatives are authorised under a licensee and employ planners (authorised representatives) to provide advice under their corporate authorised representative status.
- Small or boutique licensees are often one or two financial planners or a collective of several corporate authorised representatives operating a small business under their own licence
- Authorised representatives are commonly sole traders operating a small financial planning practice under the licence of a large or medium licensee.
- Employed planners

Professional indemnity insurance

Issues related to professional indemnity insurance may be unique to the financial planning profession and other financial services.

Section 912B of the Corporations Act 2001 requires an AFS licensee providing financial services (including providing financial product advice) to retail clients to have arrangements in place for compensating clients for loss or damage suffered arising from breaches of the licensee's relevant obligations under the law, either by the licensee or its representatives.

To meet the client compensation arrangements under s912B, Corporations Regulation 7.6.02AAA states that the licensee must hold adequate professional indemnity insurance cover.

What is Professional Indemnity insurance?

Professional indemnity (PI) insurance is a commercial product available to financial services providers (amongst other professionals) to protect them against liabilities incurred in the course of operating their business. It has been described as 'a product that indemnifies professional people ... for their legal liability to their clients and others who relied on their advice or services. It provides indemnity cover if a client suffers a loss, material, financial or physical, that is directly attributed to negligent acts of the professional'.

There is a legal requirement for the professional indemnity insurance cover held by financial planning businesses to be 'adequate', including providing cover for liability under any awards by external dispute resolution (EDR) schemes.

The main policy objective for the 'adequate' professional indemnity insurance requirement is to 'reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources'. However, the structure, purpose and role of PI insurance is to cover the insured (ie. the financial planner), not the third party consumer (client of the financial planner). Licensees exiting the financial advice industry are also required to ensure adequate 'run-off' insurance is in place for the advice that was provided under their licence to cover for potential future claims.

Regulatory Guide 126 (RG126) sets out ASIC's view on the features a professional indemnity insurance policy should have in order for it to be adequate in terms of:

- minimum requirements and features including:
 - a limit of indemnity of at least \$2 million and up to \$20 million (based on revenue)
 - cover (and no exclusions) for breaches of obligations under Chapter 7 including liability: under external dispute resolution (EDR) scheme awards; for fraud or dishonesty by directors, employees or representatives
 - excess amounts at a level that the licensee can confidently sustain
 - cover of legitimate switching from funds or products that are not on an approved product list to another fund or product on the approved product list
 - defence costs (typically these are in addition to the limit of indemnity), and
 - retroactive cover.

- factors that licensees should consider when determining what is adequate for them including the nature, scale and complexity of the business and the licensee's financial resources, as well as the maximum liability that might be incurred.

Who holds the Professional Indemnity cover?

Traditionally AFS licensees have complied with this obligation by holding PI insurance cover for all the financial products and services provided under their licence, including financial advice provided by financial planner representatives. However, changes in the advice and PI insurance markets have seen the emergence of other mechanism for meeting the PI requirement including:

- Licensees requiring authorised representatives to take out their own PI policy – this means authorised representatives who operate a small financial planning business must hold a PI policy directly.
- Licensees charge a separate fee for PI cover on top of the licensee fee charged to authorised representatives operating a small financial planning business.

These emerging options that larger licensees are using to meet their legal obligations are exacerbating the PI insurance issues for small financial planning businesses.

Small financial planning licensees are continuing to grapple with the significant issues associated with PI insurance on an annual basis. As it is a condition of the AFS licensing regime to hold such a policy, issues with PI insurance arrangements mean that a small self-licensed practice owner faces the loss of their business, their licence and potentially their chosen profession if they cannot secure the legally mandated adequate cover.

Issues related to professional indemnity insurance

The excessive cost of PI insurance is intertwined with the availability of PI insurance for financial advisers in Australia, and policy exclusions.

Common PI insurance issues for small financial planning businesses include:

- High premiums
- Lack of market competition as insurers exit the Australian market
- Exclusions
- Increasing excess
- Claims experience and expenses
- Licensees excluding PI cover from standard licensee fees and charging it as a separate cost or requiring financial planning practices to secure their own PI cover

These issues are covered below in response to the Terms of Reference of the Inquiry.

Professional Indemnity Insurance and the Inquiry Terms of Reference

That the Australian Small Business and Family Enterprise Ombudsman inquire into and report on practices of the insurance industry impacting small business and whether insurance products are fit for the purposes of small business, with particular reference to:

1. the availability and coverage of insurance policies provided to small businesses including:

- **the impact of coverage denial;**

Financial planning businesses must hold adequate PI insurance as a condition of their financial advice licence and legally are not permitted to provide financial advice to retail clients without such cover. A small self-licensed practice owner faces the loss of their business, their licence and potentially their chosen profession if they cannot secure the legally mandated adequate cover.

- **policy exclusions and how they are communicated to small businesses;**

Financial planning businesses generally purchase professional indemnity insurance through an insurance broker. The broker's role includes determining if the policy offered will provide adequate cover in line with the requirements in RG126 and for the risk of the business, and to help the financial planning business understand policy wording, definitions, exclusions and excesses.

Feedback from some FPA members indicates that brokers do not always explain the policy exclusions unless specifically asked to by the financial planning firm.

Concerns have also been raised about time pressures placed on small financial planning businesses by insurers to consider and agree to policy changes and pricing when taking out a new policy and at renewal in a restricted timeframe. Some small financial planning businesses have stated that they have agreed to renewal offers as it is a legal requirement to hold PI insurance even though the offer expiry time provided by the insurer did not allow adequate time to truly understand the policy given the complexity of the wording and definitions and the need to ensure exclusions do not put the business at risk of inadequate cover.

There is also apparent inconsistency across PI policies regarding defence costs – some policies include defence costs; others exclude defence costs.

- **the use of definitions in policy documents that create de facto policy exclusions;**

The complexity of the wording and definitions of PI policies can result in misunderstandings of the coverage with exclusions and issues only being clearly identified during the claims process.

- **the fitness for purpose of market offerings;**

When determining whether professional indemnity insurance for financial planning businesses is 'fit for purpose' it is important to consider the role PI insurance is mandated to play in relation to financial advice. Under s912B of the Corporations Act the primary purpose of requiring licensees to hold PI insurance is to ensure funds are available to pay compensation awarded by AFCA, or other jurisdiction, to a client of the firm should a complaint arise; or if a licensee provides compensation to a client directly as a result of an internal investigation.

However, there are significant limitations in using professional indemnity insurance as a consumer compensation mechanism, including:

- the total funds available under a policy may not cover all of the compensation awarded against the insured;
- the policy may not cover the conduct which gave rise to the order for compensation – for example, if the advice recommended a product that was excluded under the policy wording even if the advice and product recommendation was in the best interest of the client as required under s961B of the Corporations Act and the legislated Financial Planner and Financial Adviser Code of Ethics;
- the complex policy wording can lead to financial planning firms holding inaccurate expectations of cover being adequate for the risks of their business and the requirements in RG126, leading to claims being denied;
- the involvement of insurer’s lawyers in the claims process can make it too costly and time consuming to pursue legitimate claims, particularly by small financial planning firms;
- the amount of compensation payable may be less than the policy’s excess; and
- the claim is outside the terms of the cover – for example where a single claim exceeds the limit of the cover, or where a financial planning business experiences multiple claims in a single year of cover – this significantly undermines the performance of the cover and whether it is fit for purpose.

Policy exclusions can significantly impact the performance of the cover in terms of paying compensation to consumers and covering complaint costs of the small business.

Insurance premiums have been escalating rapidly, regardless of whether a practitioner has been subject to a complaint or a finding from an external dispute resolution process. Insurers are leaving the market. Some financial planning businesses are finding it very difficult to renew their professional indemnity insurance and taking out new cover has become problematic.

The role of PI insurance is to cover the cost to the financial planning business of compensation awarded to consumers by dispute jurisdictions. The substantial increases in excesses attached to PI policies particularly over the past two years, and the involvement of legal representation in the claims process (as discussed below), significantly undermine the value of the insurance for the business insured.

Relevant to the consideration of whether PI insurance for financial planning businesses is ‘fit for purpose’ is the identification and assessment by insurers of the risk to be covered.

There has been an increasing number of exclusions in the PI cover available to financial planning businesses, often with no reduction in premium. There is a concern that underwriters do not present a good understanding of how to assess and price risk in the financial advice industry.

Anecdotal evidence from small financial planning licensees indicates that there is a lack of explanation of how the insurer’s assessment parameters work, with no clear guidelines on the risk levels or how to reduce the risk being underwritten. It is unclear what the insurers are looking for in determining the level of risk the business presents. The questions asked by underwriters commonly relate to product failures that are not the responsibility of financial planning firms; rather than the potential risk of breaches of financial advice laws, non-compliance with conduct requirements, and consumer complaints in relation to the financial advice provided.

It appears that insurers do not differentiate the risk presented by large licensees with large numbers of authorised representatives, and small financial planning licensees with one to five representatives authorised and providing financial advice under their licence. Small financial planning firms have been informed by insurers that large premium increases are due to the broader market.

Anecdotal feedback from FPA members also indicates that insurers focus on assessing risk and providing financial planning businesses with cover based on the financial product recommended to clients, not the appropriateness of the financial advice provided to clients. For example, recent exclusions include products such as managed investment schemes, mezzanine finance, unlisted or unrated securities, unsecured loans and property developments. The PI insurance exclusions can commonly contradict the licensee's Approved Products Lists, and ignore the legal requirement for financial planners to provide advice in the best interests of their client.

There have been significant changes to the regulation of the financial advice profession over the past decade including the introduction of a best interest duty to the client, the banning of commissions, and education and professional standards. It is unclear how these changes have been incorporated into insurers risk assessments for PI insurance for financial planning businesses.

A greater clarity of the risk assessment triggers used by insurers in relation to financial advice would encourage financial planning firms to adapt their business models and advice processes to lower the risk and streamline the insurance process.

2. other issues affecting availability and coverage including:

- **any impact of the current market's lack of diversity in insurance providers, underwriters and types of insurance;**

The most significant cost for financial planning businesses is professional indemnity (PI) insurance, as required under the Corporations Act. While PI costs vary significantly depending on the financial planning practice, prices are driven up by the lack of competition in the professional indemnity insurance market for financial planners and licensees in Australia.

It is difficult to ascertain how many underwriters currently operate in the financial advice PI insurance market in Australia. The FPA has been informed that across the globe all markets for all liability classes are very difficult at present, with PI insurance for financial advice providers particularly limited. There are mixed reports regarding the number of underwriters offering PI insurance for financial advice providers in Australian.

The insurance market for PI insurance to financial planners continues to be difficult and unprofitable for most insurers. As a result insurers/underwriters are leaving the space or increasing premiums to ensure this market segment is profitable. Consequently, many financial planning firms, regardless of their claims history, are being affected with the skyrocketing PI insurance premiums, policies with multiple exclusions, and high excess amounts.

As a result of the declining competition in the market, insurers are being selective in the risk they take on because there's more demand and restricted supply. Those providers that remain have been either increasing premiums, deciding not to renew, restricting coverage and/or increasing excess amounts.

The lack of diversity and competition in the financial advice professional indemnity insurance market significantly impacts the affordability and availability of appropriate cover. The small

number of underwriters offering PI cover in Australia exacerbates the power imbalance between the insurer and the financial advice business seeking this mandatory insurance.

The impact of this issue will continue to be heightened for an increasing number of businesses due to the movement in the financial advice market away from operating under large institution licensees toward small AFS licence holders.

- **insurance policy affordability and its impact on availability, including increases in price that amount to denial of coverage;**

The Inquiry Terms of Reference refers to “insurance companies.....pricing insurance policies out of reach”. This is not an option for financial planning businesses as it is a mandatory legal requirement for all financial planning providers to be covered by professional indemnity insurance, either by holding the policy directly or by being covered by a licensee’s policy. This mandatory requirement creates a power imbalance in the negotiation of policy inclusions/exclusions, excess amounts, and price.

While the following APRA data is not specific to small licensees, it confirms significant year-on-year increases in PI insurance premiums relative to the number of insured, and continuously rising excess amounts, covering all financial advice licensees.

Premium, number of risks and excess data for professional indemnity insurance of financial advisors and planners by underwriting year

| Underwriting year | Gross written premium (\$) | Number of risks written | Average written premium (\$) | Median excess/ deductible amount (\$) |
|-------------------|----------------------------|-------------------------|------------------------------|---------------------------------------|
| 2014 | 35,678,775 | 1,070 | 33,345 | 10,000 |
| 2013 | 23,767,027 | 1,199 | 19,822 | 10,000 |
| 2012 | 17,833,362 | 1,172 | 15,216 | 5,000 |
| 2011 | 17,400,597 | 1,092 | 15,935 | 2,500 |
| 2010 | 21,279,681 | 1,868 | 11,392 | 5,000 |
| 2009 | 18,520,090 | 2,206 | 8,395 | 5,000 |
| 2008 | 14,578,441 | 2,216 | 6,579 | 5,000 |
| 2007 | 15,337,124 | 2,463 | 6,227 | 5,000 |
| 2006 | 16,439,948 | 2,428 | 6,771 | 5,000 |
| 2005 | * | * | 6,654 | 5,000 |

Source: Australian Prudential Regulation Authority (APRA), National Claims and Policies Database

Notes:

(1) More information about the APRA National Claims and Policies Database is available here:

www.apra.gov.au/GI/Pages/national-claims-and-policies-database.aspx

(2) Data marked with * have been masked to maintain confidentiality and/or privacy

(3) Average written premium is gross written premium divided by number of policies

(4) Data for 2015 not available at the time this was produced, in August 2015

(5) See the notes page for a full explanation of the nature of the data provided

(6) See the glossary for an explanation of all terms used

For small financial advice licensees, PI insurance premiums cost approximately 2 to 3 per cent of business revenue on average. Premiums are reviewed annually and in 99 per cent of cases, increase year on year regardless of the claims history of the business.

In the past, the most common industry practice is for the licensee to hold the PI insurance policy as part of the service package provided to their authorised representatives, and charge for this cover via their licensee fee, as previously stated. However, there has been a shift in recent years to authorised representatives (who run their own small financial planning business) either paying a share of the licensee's PI insurance premium separately, or the licensee requiring the authorised representative to hold their own policy.

The following FPA member case study demonstrates the impact of this change:

My PI cost changed from being bundled within my licensee fee of \$24,000 plus 3% of revenue, to a separate charge of \$10,900 (ex GST) in May 2019. The licensee fee was not reduced with the removal of the PI cost, rather the licensee fee was increased and the additional PI cost charged separately. This year the licensee has renegotiated the PI charge to \$5,824 pa. Next year will be negotiated again and may rise or fall depending on if any events occur during the year.

In May 2020, the FPA conducted a PI insurance survey with our Professional Practices with 47% of respondents stating that they had changed insurer at renewal with a significant increase in cost given as the main reason for the change. For example:

Renewal is currently in progress. We haven't claimed in 13 years on PI, have no regulatory action or major issues in the licence, but first \$10m layer is going up 25%, co-insurer on the first layer is currently wanting to go up 150%. 2nd layer wants to go up 400%. Currently in negotiation with other insurers to find a reasonable answer. I will probably drop a layer just to be able to afford it.

44% of survey respondents reported premium increases of between 10% and 24%; 18% received increases between 25% and 50%; and 15% of respondents experienced an increase of 100% or more.

Our broker tried everywhere to obtain cover but said had no other option to pay over double of previous year (\$21,000) to current year's premium (\$45,622). We are a very small advisory firm with only three advisers and no MDA [managed discretionary account authorisation].

In addition, 44% of respondents stated they were required to accept a higher excess to obtain PI cover in the last renewal period. Of those respondents who accepted higher excess amounts, 59% experienced excess increases of between 20% and 50%; and 24% of respondents had an excess increase of 100% and over.

Survey respondents offered examples of the excess in the PI cover held by some small financial planning businesses:

- *We initiated our own excess increase about 4 years ago to lower the premiums as they were becoming prohibitive. Our excess is presently \$100k on a revenue of circa \$3mil. No MDA, no adverse compliance history.*
- *Increased [this year] from \$250k to \$1m.*
- *Have had suggestions of excesses over \$100 000 (current is \$15 000) if we could find an insurance company to offer cover.*

- **current models of government support or control in Australia and internationally that facilitate affordable access to appropriate insurance for small businesses;**

There are no models of government support or control in Australia that facilitate affordable access to appropriate professional indemnity insurance for small financial planning businesses.

The financial advice PI insurance market was built for large licensees. This is symptomatic of the licensing regime and the bedding-down of the Australian Financial Services Licensing (ASFL) regime under the Financial Service Reform Act 2001, and the emergence of the financial planning profession in Australia.

Historically, AFS licences were held by large financial services institutions who authorised financial planners to provide financial advice to consumers under their licence. The authorised financial planners ran their own small financial planning business.

Due to this market structure and the FSR regime, the professional indemnity market and offering from insurers was primarily designed for large financial services institutions - the value for insurers was through the large licensee PI policy. It was not built for small businesses to hold their own policy. This legacy has continued to stymie the PI offering for small businesses.

Regulatory instability due to continuous reforms in the financial advice space since the implementation of the FSR in 2001, has added risk uncertainty for insurers and impacted affordable access to appropriate PI insurance for small financial planning businesses.

- **the role of brokers in getting the right coverage;**

A broker can assist in determining the appropriate cover for the specific needs of the business and ideally present alternative policies for consideration. Any exclusions would usually be specified in the policy schedule and the cover provided and not provided should be clearly explained by the broker.

Most small financial planning businesses rely on the advice of insurance brokers. Unfortunately, cover deficiencies can still come to light at claim time.

It is understood that of the hundreds of brokers in Australia who assist clients with PI cover, there are only a handful who specialise in PI for financial advice businesses.

The size of the financial advice PI insurance market means there are very few underwriter options for brokers to negotiate with. Brokers specialised in the PI market for financial planners tend to know the detailed risk each underwriter will or won't cover in relation to financial advice. This can occasionally lead to confusion about who the broker is acting for – the insured or insurer – as the broker will engage with the underwriter they know will cover the type of risk presented in each financial planning firm.

3. the use of contract changes that have not been agreed to and their potential treatment as Unfair Contract Terms;

The Unfair Contract Terms under the law do not apply to professional indemnity insurance.

Professional indemnity insurance does not meet the 'standard form contract' definition under s12BK of the ASIC Act 2001, as demonstrated by Example 1.4 of the Explanatory

BBB Limited is a small business seeking professional indemnity insurance. BBB Limited requests that a broker recommend the best insurance policy. The broker, acting for BBB Limited, seeks quotes from several insurers. In preparing the contracts, the broker negotiates changes to a number of specific clauses to suit the nature of BBB Limited's business. These contracts would not be considered standard form contracts and BBB Limited, as the party to the contract, cannot take action under the unfair contract terms regime.

4. the timeliness of payment of insurance payouts and the effectiveness of dispute resolution frameworks for insurance disputes;

The Australian Financial Complaints Authority (AFCA) is an ASIC approved external dispute resolution (EDR) scheme with the role of resolving consumer and small business complaints about financial firms. Small financial planning businesses are financial firms and are required by law to be a member of AFCA. AFCA does not consider disputes between financial firms.

Professional indemnity insurance is also excluded from the AFCA jurisdiction under its Rules as a small business insurance product.

Disputes between small financial planning firms who hold PI insurance, and the insurer or issuer of the insurance, are usually considered in the court system.

The purpose of PI insurance held by financial planning firms is to cover the cost of compensation awarded by AFCA, or other jurisdiction, to a client of the firm should a complaint arise.

A significant issue for financial planning businesses experiencing a complaint at AFCA is that the PI insurer takes over the management of the complaint on behalf of the business with seemingly mandatory involvement of lawyers. This significantly drives up the cost of the complaint and the resulting claim for the business, and can at times sour any misunderstanding between the financial planner and client.

Once the complaint is resolved by AFCA, the financial planning business files a claim in relation to compensation awarded by AFCA to the complainant in the complaint. Risks can arise for small financial planning businesses in the event of a claim, particularly in relation to policy exclusions, unclear policy wording, and the unclaimable costs of essential legal representation in the claims process.

This claims process is often drawn out and difficult, as demonstrated by the following case study (provided by an FPA member):

A claim for financial loss by an AFSL under a 'PI' policy. An AFSL lodged a 'fidelity' claim with the Insurer (via its insurance broker) with assistance of the AFSL's lawyers due to the complexity of the policy document. The claim resulted from the misconduct of an authorised representative which was discovered by the licensee. AFCA was not involved in this case and the licensee reported the breach to the relevant Regulator. The licensee arranged an independent investigation of the matter and provided full remediation to all affected clients.

The insurer was domiciled overseas and responded through their Australian based lawyer after several follow-ups with the broker. The insurer responded through its lawyers that the

policy does not cover the claim. The AFSL's lawyers disputed this assertion and responded appropriately.

The insurer was again very tardy in responding and maintained its position and refused to indemnify under the policy. The AFSL's lawyers provided all necessary evidence and then positioned to seek a ruling on the policy definition in the Federal Court if the insurer continued to deny the claim.

After many months of legal debate between lawyers, the AFSL was successful in its claim. Success was achieved only through perseverance and at significant legal cost in pursuing the claim (which was not recoverable under the policy).

This is an example of unnecessary and significant costs incurred by an AFSL for a loss it believed would be covered by the PI policy. Insurers' tardiness and apparent methodology to delay claims create significant legal costs for the insured that can discourage small businesses and AFSLs from vigorously pursuing legitimate claims.

Claims experience case studies highlight the complexity of PI policies required by financial planning businesses.

5. the effectiveness of relevant codes of conduct and legislation, including the adequacy of applicable penalties; and

There are no codes of conduct that apply to professional indemnity insurance.

However, brokers are subject to the NIBA Insurance Brokers Code of Practice including when providing broking services to small financial planning businesses.²

The Code clarifies that insurance brokers who are engaged by the client are acting on behalf of the client, not the insurer.

6. any other relevant matters.

No comment.

² https://www.niba.com.au/codeofpractice/NIBA_Code_2014.pdf?v=2

Individual Disability Income Insurance (IDII)

What is individual disability income insurance (IDII)

Individual disability income insurance (IDII), commonly known as income protection (IP) insurance, provides policy owners with a reasonable chance for them to reset their lives and recover in the event of an injury or illness. IDII is often taken out by small business owners, sole traders, and those with family owned businesses such as farmers.

APRA made changes to the rules for IDII which came into effect on 31 March 2020. The changes included:

- Cease writing IDII policies that provide benefits based on an agreed value income and only offer new policies based on current income at the time of claim.
- Limit benefits under new IDII policies to 100% of current income over the first six months and 75% thereafter, and set a cap on payments of \$30,000 per month.
- Limit IDII policies to an initial term of five years, with renewal only after considering occupational and financial changes.

The impact of these changes on policy holders include:

- For example, only offering IDII policies with benefits based on current income could substantially disadvantage consumers who have variable income from year to year and lead to these consumers not taking out IDII cover.
- Small business owners, farmers and contractors can have significant variations in their incomes and their IDII cover could be de-valued if a claim coincided with a low-income year, despite having paid premiums over the life of the policy.

The following examples demonstrate the impact of this change on small businesses.

Case study - small business:

For the last ten years, Jane has run her own tour guide business in Cairns. Jane's business is highly seasonal and subject to external shocks. She has had some good years with record tourist numbers boosting her income. She has also had some poor years, particularly in the aftermath of Tropical Cyclone Yasi, when few incoming tourists meant her business operated at a loss.

As a business owner, Jane is not covered by Queensland workplace compensation arrangements. Three years ago, she took out IDII cover to protect her income in the event of a workplace accident and has diligently paid her premiums for this policy. Jane had an accident at work that stopped her from working for six months while she recovers.

With an agreed value policy, Jane can be confident that she will receive sufficient benefit from her policy to cover her expenses while she recovers.

With a policy based on current income, Jane's benefit would be highly dependent on how well her business was performing in the period immediately before the accident.

- Any period of poor trading, including a broad tourism downturn caused by the coronavirus outbreak, could dramatically reduce the benefit that Jane would receive.
- If Jane had reduced her hours at work immediately after her accident, in an effort to continue working throughout her recovery, any later claim against her IDII policy would reflect her reduced hours and lower income.
- Finally, Jane would need to provide evidence for her income for that period for any IDII claim, which could be challenging if it does not align with personal tax returns.

Case study – farmer:

John owns and operates a broadacre farm near Dalby and mainly grows wheat and barley. John's income varies widely depending on the strength of that season's crops and the prices he gets. In a good year, John's farm is highly profitable. However, since 2017 the drought has caused below average rainfall and John's income has been limited.

As John's farm has low debt levels, he has been able to secure an IDII policy that will provide him with \$3,500/month of agreed value cover. If John were to be injured and unable to work, he would be confident in the policy providing him with income support.

A policy based on John's actual income, instead of an agreed value, would provide a benefit that was highly dependent on whether the claim was made in a good or poor year for the farm.

- If the claim was made in a good year, the benefit would likely exceed John's average income by a considerable margin. If the claim was made in a poor year, it may not pay a benefit at all.
- Such variability would prevent John from adequately managing his risks and make him less likely to commit to paying premiums when the possible benefit is uncertain.

Premium increases

As the new restrictions have only recently commenced it is currently unclear how the APRA changes will impact IDII premiums and whether the cover is fit for purpose for small businesses.

However, the current COVID-19 pandemic and economic crisis is having an impact on the affordability of IDII products. For example, insurer Onepath has significantly increased premiums:

Having earlier this year ceased agreed value and level premium IP [Income Protection] cover and increased premiums for new customers, the insurer has gone a step further by foreshadowing a 25% increase in base premiums (both stepped and level) for existing customers.

It has also announced a 12.5% increase in premiums for new and existing customers with respect to Total and Disability cover.³

³ <https://www.moneymanagement.com.au/news/liferisk/under-pressure-onepath-increases-ip-and-tpd-premiums-existing-customers>

Cyber insurance

With the social distancing restrictions introduced to combat the COVID-19 pandemic and the move to working from home for a large number of Australian businesses, there has been media reports and warnings from governments and regulators of an increase in cyber threats to business.

The current environment has led to confusion about the different types of insurance policies offering to cover the risks associated with cyber threats and potential data breaches, and the value of such cover for small business on top of policies already held.