



Response to the Senate Economics Legislation Committee

Treasury Legislation Amendment (Professional Standards) Bill 2003

Assessment of any impact on prudentially regulated institutions of the proposed Bill

APRA does not believe it is possible to quantify the impact of proposed caps on liability for service providers to prudentially regulated institutions. The impact of any liability arising would be assessed by APRA based on the financial ability of the entity concerned to meet its obligations to beneficiaries. The number of professions (among all service providers) on whom an institution could have a claim could include lawyers, and also professionals as diverse as engineers and architects where they are constructing new office buildings. It is also worth noting that many professionals already limit their liability within the terms and conditions of their engagement undertakings. Thus unlimited liability is likely to only apply where there is absolute gross negligence (which is difficult to define in contract and may require court adjudication), dishonesty or fraud.

As noted in evidence, institutions are already exposed to what are effective caps on the liability of service providers by their use of outsourced services. As an example, if an institution outsources its administration or IT services, it effectively is exposed to any liability beyond the extent of the service providers' capital or insurance facilities. APRA has had concerns about the possibility of service providers inappropriately (in APRA's view) limiting liability by structuring services so they are provided by a thinly capitalised entity – however, this has not been a very significant trend. The effect of the proposed legislation brings professions into a similar situation. It is certainly correct to say that the proposed legislation changes the balance of liability which should (assuming that any crystallised liability can be met out of available financial resources) be borne by the professional and the institution. However, such a balance already exists in relation to other (non-professional) service providers. In any event, for an institution to have a claim against a professional, it would need to be clear that the professional was liable in their own right for the full damages experienced by the institution. It would be likely in the case of auditors, for example, that the auditor would be able to claim that it had relied on financial material and information provided to it by the institution or other professionals (such as valuers, actuaries etc).

APRA also notes that it would be difficult for anyone to quantify the impact of the proposed legislation until it has been interpreted and applied by the courts.

From a prudential regulation point of view, APRA does not consider that the imposition of a cap on the liability of professional advisors to regulated financial institutions poses a significant additional risk to the interests of beneficiaries of those institutions. There is the potential for some adverse impact where institutions might not have a great deal of capital or those which are unprotected by capital. However,

these challenges already exist and the supervisory regime has increasingly moved towards ensuring that regulated entities properly recognise risks and put in place appropriate risk management systems and mitigants.

Institutions and APRA, already make judgements about the capacity of other (non-professional) service providers to meet any liabilities or damages that might arise from the services they provide, and ensure that the institution itself has the capacity to ensure that any short fall in damages can be met to the extent necessary to protect the interests of beneficiaries. APRA examines Risk Management Strategies developed by institutions to ensure that outsourcing risks are identified and recognised.

It is also important to note that the proposed liability caps are in exchange for improved professional standards – including risk management strategies, compulsory insurance cover, professional education and appropriate complaints and disciplinary mechanisms. These counterbalancing measures will further act to reduce the impact of liability caps on regulated institutions.



Current performance of the professional indemnity insurance portfolio of Australian insurers

Professional Indemnity data excludes insurers in run-off and medical indemnity insurers.

	31/03/2003	30/06/2003	Quarter ending 30/09/2003	31/12/2003	12 months ending 31/12/2003
Gross Premium Revenue^a	171,936	261,605	246,141	325,463	1,005,145
<i>Claims Expense:</i>					
Relating to current & prior years ^b	116,943	180,572	124,629	197,628	619,772
Relating to future years ^c (ie movement in premium liabilities) at 75% sufficiency^d	12,539	63,607	10,100	33,826	120,072
Relating to future years ^c (ie movement in premium liabilities) excess provisions^e	1,238	-5,593	-1,664	-697	-6,716
Gross Claims Expense	130,720	238,586	133,065	230,757	733,128
Gross Loss Ratio ^f	76.0%	91.2%	54.1%	70.9%	72.9%

Technical material on the data

- a) Premium revenue is fully recognised on the date of acceptance of risk. It is not deferred and amortised in accordance with AASB1023. It is reported by class of business on GRF 310.1: Premium Revenue and Reinsurance Expense.
- b) This reflects claims paid during the current year and movements in the Outstanding Claims Provision (OCP). It is reported by class of business on GRF 310.2: Claims Expense and Reinsurance Recoveries. The OCP used is based on that reported on GRF 300.0: Statement of Financial Position, which may be higher than that required by GPS 210: Liability Valuation for General Insurers.

- c) The prospective nature of GPS 210 requires measurement and recognition of the claims liabilities likely to arise from premium business that has been written. These liabilities are reported as Premium Liabilities on GRF 300: Statement of Financial Position. The movement in Premium Liabilities reported on GRF 300 is to be recognised as a claims expense relating to future years on GRF 310.0: Statement of Financial Performance. It is not reported by class of business, and is therefore estimated for PI as the sum of the two calculations below d) and e).
- d) GRF 210.1: Premium Liabilities - Insurance risk charge reports Premium Liabilities by class of business in accordance with GPS 210. This standard requires liabilities to be valued at the 75% level of sufficiency. The movement of reported values on GRF 210.1 over the period represents an estimate of claims expense on future years (at the 75% level). However, it should be noted that the holdings of Premium Liabilities on GRF 300.0 (which drive the actual claims expense on GRF 310.0) do not necessarily have the same class break-down as on GRF 210.1 used for the estimation (particularly in relation to risk margins).
- e) Premium Liabilities held by insurers (reported on GRF 300.0) may be in excess of that required by GPS 210 (reported on GRF 210.1), ie at a higher level of sufficiency than 75%. Movements in this excess portion also form part of the claims expense on future years. As this is only reported in aggregate on GRF 300.0, this excess is simply apportioned pro rata between the classes based on GRF 210.1 values. Due to the relatively minor impact of this excess on insurers writing PI, more involved modelling has not been attempted. However, as the various classes have different claims distributions, this estimate is unlikely to be accurate. Insurers may also choose to only hold an excess in certain classes and not others.
- f) It is important to note that this gross loss ratio is not directly comparable to gross loss ratios produced under the previous reporting regime. Both the claims expense and premium revenue used in the calculation have undergone a significant change in basis due to the prospective nature of the new framework.