Supplementary Submission to the Senate Economics Legislation Committee

Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003

7 April 2004

Table of Contents

Why PSL with Liability Limitation is Essential

Professional Standards Legislation (PSL) has been proposed as a solution to the market failure in professional indemnity (PI) insurance that is resulting in insurance being unaffordable or unavailable for many professionals for the full range of services they provide.

The benefits and purpose of PSL have been accepted by insurance ministers, who reaffirmed their unanimous support for this reform at the recent meeting in Hobart. Underlying ministers' support for PSL is the recognition that market failure exists in PI insurance, in that the market has not been able to provide adequate, affordable insurance to cover the full range of services provided by professionals. Ministers have accepted that nationally consistent PSL, as part of an integrated package of reforms including the introduction of proportionate liability, changes to section 54 of the Insurance Contracts Act and changes to relevant Commonwealth legislation to give effect to State and Territory PSL initiatives (which is the purpose of the Bill that is the subject of the present inquiry) will assist in attracting capital back into the PI insurance market and better protect consumers of professional services.

If PSL is not adopted, the following outcomes can be expected:

- The market failure for PI insurance will not be corrected. Professionals will continue to be exposed to potential liability far in excess of available PI insurance cover for many of the services they provide (and which the community relies upon).

- In the meantime, there is the certainty (as confirmed by the recent ACCC report on insurance and by strong anecdotal evidence from the crucial London insurance market) that PI insurance will continue to rise in cost, as well as become increasingly unavailable, particularly for services perceived to be higher risk.

- The high cost and unavailability of insurance will result in increasing pressure on professions to reduce or abandon mandatory PI insurance requirements (e.g. changes made last year by the Institute of Chartered Accountants in Australia [ICAA], reducing its PI insurance requirements for members). Associations cannot mandate requirements that the market cannot meet.

- The alternative is that many professionals will be forced to resign their professional membership if they cannot insure to the level required by their professional association. Such members will not be subject to the rules and disciplinary oversight of their professional body, to the detriment of consumers. The authority of the professional associations to self-regulate will be significantly diminished.

- Consumers will be at greater risk because many service providers may be unaccredited and uninsured and will not be compelled to disclose this to consumers.

- Many service providers will respond by seeking means other than insurance to protect themselves in the event of liability claims, by divesting themselves of personal assets and "running bare" (i.e. without insurance). Consumers will again suffer as a consequence.

PSL is designed to ensure that:

i) Insurance exists to support plaintiffs who obtain successful verdicts or settlements;
ii) Damages awards can be contained to insurable levels; and
iii) Claims against professionals are reduced through comprehensive risk management.

PSL is in the broader public interest. As PSL requires professionals to be insured or have assets to the level of their liability ceiling, and because PSL will encourage insurers back into the PI market, the result will be that resources will be available to compensate successful plaintiffs, meaning **actual recovery of damages by plaintiffs is likely to be higher under a system of PSL** than without it. Liability ceilings would also be set at a limit where all consumer claims and the vast majority of commercial claims would be met in full. Further, risk management schemes under PSL are likely to result in an improvement in standards of professional and occupational practice and a lower incidence of claims arising against PSL scheme participants.

Passage of the Treasury Legislation Amendment (Professional Standards) Bill 2003 is an essential measure. Without it, the reforms agreed and worked on with bi-partisan support by the Federal and all State and Territory insurance ministers will be ineffective, to the detriment of professionals and consumers of professional services alike.

Contracting out

It cannot be stressed too highly that permitting "contracting out" of PSL schemes will undermine the public policy objectives that insurance ministers seek to achieve through this important legislative reform. The PSL model that must be adopted nationally is the model that exists in NSW, WA, Victoria and (prospectively in) South Australia, in each of which contracting out of PSL schemes is prohibited.

The purpose of PSL is to improve protection of individual and small business consumers of professional services, through mandatory PI insurance, better risk management and higher standards of professional conduct (through continuing professional education, quality assurance programs, application of codes of professional conduct, complaints handling and investigation procedures, and application of disciplinary procedures). The issue of why professional standards and risk management can be expected to be better under a system of PSL is addressed below. However, PSL has been shown to result in fewer claims arising, as evidenced by experience in NSW where, for example, following the introduction of the Solicitors' Scheme the number of claims notified against lawyers fell by almost 50 per cent between 1999-00 and 2001-02.

To achieve this community goal, PSL enables professionals to limit their civil liability (though NOT in respect of claims arising from personal injury or death, fraud, dishonesty or breach of trust) under schemes approved by an independent body (the Professional Standards Council) after an exhaustive assessment of the proposed scheme and consultation with stakeholders. Approval of schemes is vested in the relevant Minister and avenues exist for review of schemes, appeal against schemes and disallowance of schemes, should this ever be warranted.

"Contracting out" of PSL schemes has been prohibited under all existing Professional Standards Acts and Bills and continues to be emphatically opposed by professional groups, the Professional Standards Council and by the Insurance Council of Australia, for the reasons that it would make PSL unworkable and would destroy the schemes established under it.

The pressure to permit contracting out – allowing parties to contract higher liability levels than those set under an occupational scheme amounts to the same thing – is in effect the transfer of entrepreneurial risk in the corporate sector and public sector risk in the government sector to professionals via PI insurance. If this succeeds it will mean PI insurance will continue to disappear.

Should contracting out in any form be permissible, large corporate clients (and government departments and agencies) will use their market power to impose higher (or no) liability ceilings or refuse to deal with the professional in question. Clients would regard the liability ceilings set in schemes as the starting point for bargaining higher liability limits. In effect, there would be no fixed system of capping – all liability limits would be negotiable, and negotiable in favour of the more powerful client.

Without an effective ceiling on liability, professionals and their associations would be committing to expensive risk management processes and compulsory PI insurance, and still be left in the situation where they have to buy as much insurance as they can find and afford. "Running bare" (without insurance) and protecting their assets through other means would, for many, appear to be a better alternative than joining schemes of this kind, particularly for vulnerable small and medium-sized professional practices left at the mercy of larger clients.

Arguments for permitting contracting out are based on a misunderstanding of how PSL works and on the wrong premise that schemes do not cater for higher liability assignments. Professionals accept that there is a need to cater for higher liability assignments under PSL and indeed there are existing schemes (e.g. the NSW Solicitors' Scheme) that provide for liability ceilings of up to $50 million (which in the case of the Solicitors' Scheme is an amount that exceeds all known judgements or settlements against members of the profession). Rather than necessitating contracting out, catering for high liability assignments means having schemes that are properly designed and which are structured to meet the generalised needs of clients and professional firms of different sizes. Each scheme does and would allow for different levels of caps, including the possibility of allowing firms the flexibility to select higher liability caps to apply for all assignments, as is the case under the existing Solicitors' Scheme in NSW. This answers the criticism made by some that caps are inflexible and do not allow firms to "compete" on the basis of their liability exposure.

Schemes must be realistic given all relevant factors, including the expectations of the market (clients) as to what is reasonable compensation in the event of fault by a professional providing a service, the professional's perception of what risk he or she is willing to accept to provide the service, and the willingness and ability of the insurance market to insure the service.

In other words, setting appropriately high levels of caps achieves the objectives sought by those advocating contracting out, without sacrificing the community benefits of a nationally consistent PSL regime.

It needs to be remembered that what constitutes an appropriate liability limit is a matter for a detailed assessment by the Professional Standards Council, which must then be approved by the relevant Minister in each jurisdiction. Limits proposed by associations need to be supported by evidence of claims experience against members of the profession. The process of assessing applications for schemes, including the liability limits proposed, provides the opportunity for public consultation and input from all interested persons, including professional service clients and government agencies. Liability ceilings are set at appropriate levels where the vast majority of successful claims continue to be met in full.

Allowing contracting out will make schemes unworkable, exposing professional firms to unreasonable liability limits and insurance requirements forced on them by larger and more powerful corporate clients, and in short time destroy schemes established under PSL. Rather than comply with the onerous obligations of PSL schemes, professionals will opt out of schemes or associations will retire schemes that have been established. Rather than having no adverse consequences on the goals of PSL, contracting out will result in those goals being unachievable.

PSL's public policy objectives – to facilitate the improvement of occupational standards of professionals and others and to protect consumers of professional services (by ensuring that resources exist in the form of compulsory insurance to satisfy successful claims against professionals) - are best achieved by ensuring broad and comprehensive application of PSL regimes to professionals. Allowing contracting out is contrary to this objective. Ideally schemes should apply on a compulsory basis to persons who are intended to be subject to schemes.

It is understood that the refusal of clients (particularly government clients) to grant work to participants in the Engineers' Scheme under the NSW Professional Standards Act was a reason (along with concern that the Trade Practices Act undermined the protection afforded by the scheme) that the scheme was not renewed after its initial term.

Rather than contracting out being a "voluntary act" by professionals, it would be forced upon professionals by larger corporate clients who would use their market power to ensure that professional firms carry corporate risk via the professional's PI insurance.

It is understood that already at least one of the major banks is specifying to prospective suppliers of professional services that the firms must not be members of PSL schemes. If contracting out is allowed, this will become standard practice for banks which will use their significant market power to force professionals out of PSL schemes.

Risk shifting

Over the course of the past 25 years the risk exposure of professionals has increased in breadth and depth. The field of professional negligence has developed rapidly, exposing professionals to ever-greater risk. Historically, professionals have stood behind the advice they provide and been prepared to meet the consequences of their mistakes. However, that is no longer possible given the pace at which their potential liability has escalated, driven by developments in the law of negligence, the increasing proliferation of claims against professionals under section 52 of the Trade Practices Act and the increasing trend to litigation given additional impetus by the emergence of a plaintiff lawyers group and litigation funders.

On the issue of whether PSL shifts the risk of liability above a cap away from professionals to other parties, it needs to be stressed that risk has progressively been shifted onto professionals over the past two decades, with professionals' liability exposure increasing dramatically over this period. Professionals' PI insurance has in fact been underwriting entrepreneurial risk in both the corporate and government sectors.

Just as with public liability, there is an urgent need to rein-in community expectations as to the level of damages that can be paid because insurance cannot operate to spread the quantum of risk that now exists. The primary beneficiaries of safety ceilings in literally dozens of situations legislated under State and Federal law ultimately are plaintiffs, where the policy decision has been made that it is better to be able to provide adequate compensation to a certain level than no compensation at all because insurance has collapsed. Similarly, it is consumers of professional and occupational services who stand to benefit from liability ceilings under PSL.

Rather than PSL representing a shift in risk away from professionals, PSL is about the appropriate allocation of the burden of risk, as correctly identified by Treasury officers in evidence to the Committee.

The Australian Bankers Association submission to the inquiry argues that the Accountants' Scheme in NSW passes liability risk above the cap to consumers of services who have no ability to manage those risks. The specific example is given of banks that manufacture and distribute financial products relying on accounting and tax advice as to the effects of those products. If the products are defective because of the advice, the submission asserts the "banks will end up assuming virtually the full burden of the liability risk for the accountant/tax adviser without any ability to manage that risk...".

The example given by the ABA, rather than illustrating that the banks are unable to manage the risk of liability above the cap, highlights that the bank is indeed the party best placed to manage the risk. In this example, the professional provides a single piece of advice to a single client for a single fee. The decision on what to do with that advice, how to interpret that advice in relation to the product, how to adapt or change the product on the basis of the advice, how to market and sell the product, and to whom and for how much (decisions which ultimately determine the size of the potential liability that might result from failure of the product), rests entirely with the

bank. It is extraordinary to suggest, as the submission does, that the bank has no ability to manage that risk.

The tenor of the ABA submission reflects the banks' interest in being able to continue to shift their risk onto professional advisers and onto the PI insurance of that professional. Professionals' PI insurance cannot continue to underwrite business risk in the corporate sector, which is one of the reasons that market failure exists in relation to PI insurance. A proper allocation of risk is needed, and that is what PSL sets out to achieve.

The professions have consistently said that most parties will not face a cap. Caps under specific schemes would be set at such a level that all consumer and most commercial claims would not reach the cap level. Average settlements and awards against both solicitors and accountants fall considerably below the threshold level of $500,000 that applies under PSL in NSW. The overwhelming majority of claims by number against professionals fall below this level (for example, it is understood that in the case of the accountancy profession, in excess of 95% of claims are for amounts below $500,000). This means that these claims will not be subject to ANY cap and if successful will continue to be payable in full. The assertion made by the ABA in evidence that consumers claiming amounts below $500,000 will be only able to recover ten times the fee for the service is incorrect and demonstrates a lack of understanding as to how the scheme in fact operates.

For the overwhelming majority of claimants PSL is advantageous in that there is an increased likelihood of a claim being able to be met (through the professional having insurance or a required level of assets), and consumer protection measures such as risk management, professional education, and complaints and discipline mechanisms.

Although in rare cases some parties will lose the right to damages above the cap (which is only of value if the defendant is able to satisfy that amount, and with the decreasing availability and coverage of PI insurance that is becoming increasingly unlikely), the professions believe PSL is fair in these cases because such parties (who will generally be institutions rather than individuals): (a) obtain the advantages referred to above in relation to smaller claimants; and (b) should be better able to protect their interests than less sophisticated parties.

Moral Hazard and Immunity from Failure

Both the Australian Bankers' Association and a number of questions posed by Committee members address the issue of "moral hazard" and suggest that PSL will render professional firms immune from failure.

The moral hazard argument in essence is that professionals whose liability is capped will have less incentive to perform their duties diligently than they would if they faced unlimited liability for the consequences of their acts and omissions.

The argument could equally run that a professional with insurance is less likely to take all due care in carrying out their duties than a person who does not have insurance, though neither the Australian Bankers' Association nor any Committee members have suggested that professionals ought not hold insurance. Similarly, no one suggests that banning seat belts in cars will lead to safer driving and reduce the road toll.

There is a point beyond which the marginal effect of an additional financial penalty on a professional's incentive to perform his or her job well will be zero. Professionals accept that liability caps ought to be set at levels that provide sufficient incentive for tasks to be carried out with due care and diligence.

However, if liability remains unlimited, or if the liability risk is perceived to be disproportionate to the gains to be made from providing the service, then professionals will continue to respond in other ways, namely by withdrawing from the provision of high risk services, or in some cases by structuring to minimise their available assets.

Firms with a poor record of risk management and adverse claims records will not be immune from failure. Such firms will face increasing difficulty in obtaining insurance cover at affordable levels as well as face the market consequences of diminished reputation, either of which could result in the failure of a firm.

At present a firm may fail as a result of a successful liability claim against it, but there is no guarantee that the firm will have adequate, or any available assets, to satisfy the claim. Under PSL consumers will be protected by the requirement for that firm to have PI insurance and other business assets to satisfy claims to the level of the applicable cap.

The Impact of PSL on PI Insurance

A national system of PSL, by providing safety ceilings on claims and mandating risk management schemes and other consumer protections, will have a significant beneficial impact on insurance as insurers will know the ceiling for which claims can be made. This will allow them to cost their risk with certainty. Such certainty will encourage insurers back into the market, thereby increasing competition and resulting in cost reductions through market forces driving down premiums.

Evidence for such a result is provided by interviews conducted in 2002 by Trowbridge Deloitte on the likely effect on the availability and affordability of PI insurance following the introduction of proportionate liability and PSL schemes nationally. Trowbridge Deloitte concluded that the reforms would provide a significant improvement in the availability of PI cover for professional advisors and in due course premium savings of approximately 20% for smaller firms with greater premium savings possible for larger firms.

Importantly, Trowbridge Deloitte concluded that without such reforms, obtaining professional indemnity insurance would become increasingly difficult in future, with further steep increases in premiums and the strong possibility of cover being unavailable for some groups.

PSL can be expected to have an immediate and positive impact on the PI market if implemented in all jurisdictions for the following reasons:

1. Premium savings will accrue to professional advisers because PSL will remove the need for high-level "catastrophe" cover. For high layers of protection, there is in effect a minimum price to pay for each dollar of cover, regardless of the likelihood of a claim being made on it (the "minimum rate on line"). It has been estimated that removal of the need for high level "catastrophe" cover will result in significant premium savings, possibly in the order of 30% - 40% (source: Trowbridge Deloitte, November 2002).

2. The reduction in demand for such high levels of cover is also likely to free-up insurers' capital enabling it to be redeployed to lower levels of cover. This will also make such cover more available and, in due course, more affordable (source: Trowbridge Deloitte, November 2002).

3. PSL will also potentially reduce the average size of claims because of the application of the liability ceilings. This will produce premium savings in the primary (or low level) insurance covers. More modest premium reductions can be expected (source: Trowbridge Deloitte, November 2002).

4. PSL will reduce the volatility of PI insurance risk for insurers by preventing "spikes" of extraordinary liability exposure that can arise even from low fee assignments. This will provide greater certainty for insurers and enable them to provide a more predictable, stable PI insurance product.

In short, PSL will reduce the need for "top-up" cover at high layers of insurance, "freeing" capital that can then be re-supplied at lower insurance levels. Increased capacity will tend to decrease costs. Secondly, it will reduce the risk of "spikes" in insurance claims that can impact dramatically on insurance profitability.

Questions by Committee members sought information on the significance of large claims in driving PI cost and availability. Whilst evidence was given that it is the weight of small claims that predominantly drive PI insurance supply and cost, the significance of large claims must not be discounted.

Insurers seek to avoid volatility in an insurance book and introducing liability ceilings for professional indemnity will result in more predictable outcomes for insurers.

Large payments of damages are rare (there are fewer large verdicts and settlements than large claims) but nevertheless their possibility has a serious impact on PI insurance profitability and hence the preparedness of insurers to underwrite risk, as is the case in public liability insurance.

As reported by Trowbridge Deloitte, there is general consensus amongst insurers and reinsurers, when writing excess business, that they are more concerned about the risk of a large individual claim rather than a series of smaller claims during a year. This is particularly the case for engineers and architects, where many years of claim-free experience can be negated by a single event.

Under a PSL scheme, with compulsory PI insurance requirements, one could expect underwriters to re-enter the Australian market including in relationship to a particular scheme membership as there would be a pool of professionals insured and therefore a spreading of risk.

Under the current situation, underwriters in their risk selection process either decline coverage, not wanting to invest time and effort in the process (particularly for smaller professional firms) or price their products accordingly. This reduces not only the aggregate insurance capacity, but also the number of underwriters – again an example where a national PSL scheme would promote the competition policy regime.

The proposition that PSL will reduce the cost of PI insurance and increase its availability has been endorsed by the Insurance Council of Australia, which notes that having a limit on the liability of a professional produces insurance premium savings, which help contain the cost of professional services (source: Insurance Council of Australia Professional Indemnity Briefing Note, August 2002).

Australian governments already apply various capping measures to ensure that the community can provide a level of restitution to people who are injured at work or in motor vehicle accidents while ensuring such coverage remains affordable, whether the cover is supplied by private insurers or government-owned organisations. Caps and other limitations on benefits have also been introduced in respect of public liability and medical misadventure in some states in order to limit costs to levels that the community is perceived to be able to afford, either through insurance premiums, self-insurance costs or taxation.

Policy makers and the community ought to be concerned by the prospect of commercial PI insurance disappearing completely. Similarly to public liability and medical indemnity, PI insurance is in crisis due to market failure – the inability of professionals to obtain adequate, affordable insurance for the range of services they provide. Without legislative intervention in the market (i.e. introducing a safety ceiling on maximum liability under PSL) the "de facto cap" (in effect the indemnity level that insurers are prepared to write for many services) could be zero if insurers continue to withdraw insurance cover for services that are perceived to be higher risk. This is particularly the case for a small country like Australia with a small premium pool and limited available capital for insurance, but which is at the same time high risk and highly litigious.

It needs to be emphasized that the issue is not only the cost of insurance, but moreover the availability of insurance. PI premiums are a serious issue for professionals, but the greater problem is the unavailability of insurance and the increasing range of matters that are being excluded from and refused policy cover.

Without market intervention in the form of PSL, there must be real concern that PI insurance will not be available for many services and their providers in the future. It is already unobtainable for many professional services provided to businesses and the general community. Surveys conducted over the past 12-24 months reveal that a range of more than 30 services provided by members of the accountancy and engineering professions alone have been refused or restricted insurance in this time, including:

- Company audits
- Audits of superannuation funds
- Audits under state legislation
- Audits of government business enterprises
- Financial planning
- Investment advice
- Tax advice
- Pollution monitoring and control
- Asbestos removal
- Environmental clean-up
- Bioremediation
- Heating, ventilation and air conditioning inspections (legionnaire's disease)
- Geotechnical services

Consequently, consumers are at risk of there being no insurance to meet successful claims, of being unaware that they may be dealing with unaccredited service providers who are not subject to the controls and regulations of a professional body (where the service provider's inability to obtain insurance to comply with an occupational association's insurance requirements has seen the person resign their membership of that association), and at risk of not being able to access vital services which will be the inevitable result of insurance unavailability. This is particularly the case in regional Australia where higher risk professional services have been withdrawn. These facts will become increasingly evident to consumers if the PSL solution to market failure is not implemented.

Flexibility

Schemes that do not allow contracting out, like the present Accountants' Scheme and the Solicitors' Scheme, are according to the Australian Bankers' Association (ABA) "inflexible".

PSL schemes can be designed in a way that permits flexibility in the caps that apply, as illustrated by the example of the Solicitors' Scheme. The Solicitors' Scheme in NSW is designed so that the maximum cap, which is matched to compulsory PI insurance, increases on a sliding scale in line with the size of the firm. However, any firm of any size has the flexibility to elect to have a higher cap, up to an overall ceiling of $50 million, enabling firms to compete on an equal basis where liability limits are an issue of concern to clients. The Accountants' Scheme sets the liability ceiling as a multiple of the fee for the service, subject to a threshold minimum level of $500,000 below which all claims are met in full and up to an overall ceiling, which at present is $20 million. This means that all firms compete on an equal basis and that liability ceilings automatically increase with the size or complexity of the service, as measured by the fee. Both schemes offer the ability for all firms to compete on an equal basis.

In short, PSL schemes can be designed in a way that allows a flexible approach to capping without resort to "contracting out".

However, caps at some point must be "inflexible" as the purpose of caps is to contain liability exposure. By describing caps as "inflexible", the ABA is simply indicating that it is opposed to capped liability and believes that corporate clients such as the large banks should be able to continue to shift unlimited liability risk to their professional advisers and service providers.

Again, the point needs to be made that PSL seeks to ensure that caps are set at levels where consumer claims are not subject to capping. In the case of large claims by corporate clients who are well placed to manage and control their own risks, PSL seeks to establish an appropriate allocation of risk and to maximise actual recovery of damages by ensuring that risk associated with professional services remains insurable. Transferring corporate risk to professionals will simply result in the continued evaporation of commercial PI insurance.

For the most part, firms of similar size and structure offering similar services will work on similar risk/reward ratios and have similar capacity to access and afford PI insurance. Their ability or willingness to compete on the basis of their maximum liability will not differ greatly.

Why are incentives needed for professionals to adopt best practice risk management?

Some questions asked by Committee members and indeed the commentary on PSL contained in the CLERP 9 discussion paper noted that whilst the risk management aspect of PSL was admirable, professions should be implementing these measures as a matter of best practice.

Many professions would reply that they have attempted to do so. Insurers might respond by questioning the effectiveness of these programs in the absence of incentives for professionals to adhere to them strictly.

PSL does provide incentives for better adherence by professionals to risk management. Crucially though, by linking risk management to ceilings on liability limits, not only are professionals provided real incentives to adhere to professional requirements by PSL, associations are given significant leverage to impose high standards on members.

Risk management programs such as the accountancy bodies' quality review program are costly to run and the cost is borne by members. Members can more readily accept such costs when they are part of a package that includes liability ceilings, as is the case under PSL.

Risk management under PSL has the following advantages:

- Independent review and assessment of risk management practices – PSL requires professional associations or other occupational groups to submit their risk management strategies to an independent body for evaluation prior to schemes being approved.
- Greater accountability on the part of professional bodies and occupational groups for the risk management processes they impose – associations are required to report annually on the risk management programs they have implemented for members and on the effectiveness of these programs.
- Greater transparency of risk management programs – schemes are accessible to the public and annual reports on schemes are published.
- PSL enables comparative benchmarking between professions and between occupational groups and facilitates exchange of information and knowledge between them.
- PSL achieves a consistency and simplicity of regulation of professions and other occupational groups that is otherwise absent.

The effectiveness of PSL in positively influencing the cost and availability of PI insurance is due to the effect of safety ceilings **in combination with** risk management.

In the absence of PSL there is, for most professions, no comprehensive regulatory framework that requires professionals to be insured. In recent times, some professions have been forced to reduce their mandatory insurance requirements and others are understood to be considering abolishing mandatory insurance altogether as

professionals simply cannot obtain the insurance they require given the inability or unwillingness of insurers to underwrite PI risk.

The introduction of PSL in NSW has led to increased levels of PI insurance for many members of the accountancy profession (the minimum PI insurance requirements for sole practitioner members of CPA Australia and the ICAA doubled from $250,000 to $500,000 because of the NSW PSL). Further, whilst serious market failure in PI insurance forced the ICAA last year to reduce its minimum PI insurance requirement for all firms to only $500,000, the existence of PSL in NSW means members in that State alone must continue to insure to the level of the applicable liability ceiling, up to $20 million.

With regard to the effect of the risk management component of PSL, insurers have indicated strong interest in PSL as a means to improve standards across professions.

It is the case that professional bodies can and do adopt their own standards of risk management without the need for legislative backing. Most professions have long experience with setting and monitoring professional standards and conduct.

There is a considerable divergence between the regulatory models that apply to different professions, and even differences that exist in the way the same profession may be regulated in different States within Australia. A multiplicity of Federal and State legislation describe the functions, activities and responsibilities of a range of professional and non-professional service providers. Accordingly, the standards of risk management currently required of professionals vary across the different professions and according to different statutes within a complex and diverse co-regulatory environment.

For the majority of professional bodies and occupational groups, membership is not compulsory but is the voluntary choice of the individual. Where members find the requirements of membership too onerous, it is open to them to resign their membership and, in many cases, continue to offer services to the public. If this were to occur, such persons would not be subject to the self-regulatory rules and standards imposed by the professional body or occupational group, to the detriment of consumers.

The greater transparency of risk management and accountability strategies under PSL is in the interest of consumers and should assist in encouraging insurers to recognise that professions and other occupational groups with such schemes are better insurance risks.

Effectiveness of Existing Schemes under NSW PSL

Committee members asked questions on the subject of the effectiveness of existing schemes under NSW PSL.

Evidence has been provided on the positive effects of schemes on PI insurance costs (from engineers), on reducing the number of claims against scheme members (NSW solicitors) and raising the minimum PI insurance requirement for sole practitioner accounting firms.

However, submissions have also highlighted that the NSW scheme in isolation has not resulted in marked improvements for scheme members (accountants).

The latter is not a criticism of the PSL concept. It is merely a reflection that, as the law presently stands in States other than NSW and in the Federal sphere, the NSW legislation can be by-passed by "jurisdiction shopping" (i.e. bringing an action in a jurisdiction other than NSW that does not have PSL in operation, a particular concern for national partnerships) or by framing actions under Federal law alleging misleading and deceptive conduct under the Trade Practices Act, the ASIC Act or the Corporations Act.

Once the Treasury Legislation Amendment (Professional Standards) Bill 2003 is enacted and a national system of PSL is in place in all States and Territories, this limitation on the effectiveness of the NSW PSL will no longer be relevant and the full benefits of PSL will ensue.

Application of PSL to Physical Injury Cases

The Australian Plaintiff Lawyers' Association, both in its submission to the Committee and in evidence, suggested that PSL either does, or might at some future time, apply to liability claims arising from personal injury.

This is incorrect. All existing PSL expressly excludes liability arising from personal death or injury. In the history of the long-standing NSW and WA PSL, as well as more recent debate with insurance ministers to create a national system of PSL in all Australian jurisdictions, PSL has consistently been proposed to apply only to liability arising from financial and economic loss.

Governments have addressed insurance issues relating to personal injury and death though other means and no proposals exist to extend PSL into this area.

Size of Caps and Scheme Approval Processes

The Australian Bankers' Association in its submission to the Committee states that caps are set by the relevant professional association with the "consent" of the PSC, not set by individual firms or by the market. It alleges the role of associations in establishing capping schemes is "potentially anti-competitive, anti-consumer". According to the submission, "schemes are proposed by occupational associations and approved by a Professional Standards Council which may not have adequate consumer representation".

The submission further asserts: "It is not clear that the amounts of the caps on liabilities has been struck by reference to the level of affordable cover obtainable by accountants or other professionals."

However, in truth, caps are **proposed** by professional associations. The PSC evaluates, analyses and assesses (not "consents to") the proposal in line with supporting information on claims data and history and insurance availability and cost. The review process must specifically consider the likely impact of schemes on consumers. The PSC is comprised of persons appointed by the Minister with the necessary skills and experience to carry out the functions of the council, including importantly, its function to "protect the consumers of services provided by professionals and others" (one of the prime objects of the NSW PSL). The suggestion that the PSC "may not have adequate consumer representation" is without foundation.

After a review process that takes at least seven months or longer, and after public submissions are considered, the PSC will make a recommendation to the relevant government Minister on whether a scheme, including the capping proposal, should be approved. Approval then rests with the minister. Neither the PSC, nor the Minister, simply "consents" to caps proposed by professional associations.

Professional associations play a vital and legitimate role in regulating professional conduct and behaviour and do not simply act in the interests of their membership. The suggestion that the role of professional associations in establishing schemes is potentially anti-competitive and anti-consumer is again without foundation. Schemes can be and are designed to have the flexibility to enable all scheme members to be able to compete on equal terms. Schemes are also pro-consumer in that they are designed to improve professional standards and conduct, improve risk management procedures, minimise the risk of claims occurring and ensure that in the event that successful claims do arise, consumers are protected by the security of mandatory PI insurance to the level of the cap. Caps are set so that the overwhelming majority of successful claims against professionals, and all consumer claims, are not subject to capping.

Further, as discussed above, associations must provide information that is as comprehensive as possible on the cost and availability of PI insurance and on the claims experience of the profession to the PSC in its application for a scheme. Caps are therefore struck by reference to the level of affordable insurance cover obtainable by the profession.

Sunset Clauses

The Australian Bankers' Association submission to the Committee and the Australian Plaintiff Lawyers' Association in evidence to the Committee both suggested the need for professional associations with schemes under PSL to annually justify the continuing need for their schemes. Where associations cannot demonstrate the continuing need for schemes, schemes should be "terminated immediately".

Schemes under PSL do have a sunset clause. Schemes remain in force for a set period of time, as determined by the Professional Standards Council, and that period shall not exceed five years (subject to the possibility that the Minister may extend a scheme for one further year). After this time an association must reapply to the Council to have a scheme renewed, and such application for renewal is assessed with the same rigour and diligence as the application for the original scheme.

Further, at any time the Minister may direct the Council to review the operation of a scheme, including determining whether that scheme should be amended or revoked.

Professional indemnity claims are also "long-tail" claims in that considerable time can pass between the act or omission giving rise to the claim and the claim itself. Generally speaking, there is a six year period within which a claim may be lodged by a plaintiff.

In short, existing PSL sets sunset clauses on schemes that are appropriate given the need for predictability and certainty in the insurance market, the nature of claims made against professionals, the length of time in which actions may be brought, and the nature of the market for PI insurance. Further, should there be any change in circumstances that warrants review of the scheme's continuing relevance, mechanisms exist for such review and possible revocation if required.

One of the objects of PSL is to ensure that professionals can obtain insurance for their occupational risk. It is irrational to suggest that should a scheme be successful in its objective of ensuring that professional risk is insurable by restoring predictability and certainty to professionals' risk exposure, that the scheme ought to be "terminated immediately".

Commencement of Schemes

In evidence to the Committee the Australian Plaintiff Lawyers' Association suggested the need for the Commonwealth to utilise its reserve powers under the Bill to ensure that liability arising from causes of action that pre-date the commencement of schemes under PSL are not subject to capping.

Existing PSL already makes it clear that schemes can only limit occupational liability in respect of a cause of action founded on an act or omission occurring during the period a scheme is in force.

Any concern that PSL will operate to limit liability for causes of action that pre-date PSL is unfounded. PSL will only operate in respect of a cause of action founded on an act or omission occurring during the period when a scheme is in force. Professionals further are required under PSL to provide notice to their clients that their liability is limited.

Involvement of Other Regulatory Bodies in Scheme Approval

The Australian Bankers' Association submission suggests that before PSL schemes come into effect, the Australian Competition and Consumer Commission (ACCC) and appropriate prudential regulators should also be required to approve them.

The PSC is the statutory body expressly created to advise Ministers on approval of schemes, after appropriate consultation with all stakeholders. Adding additional layers of regulatory approval would be wasteful and time consuming, as the ACCC and other regulatory agencies will have an opportunity to comment on schemes as part of the consultation process built into the scheme approval process.

Discussion Re: CLERP 9 Commentary on PSL

At the recent hearing, Committee members made reference to the CLERP 9 Discussion Paper commentary on auditor liability, and in particular to its rejection of proposals made by accountancy bodies that auditor liability ought to be capped. Treasury officers giving evidence to the Committee were asked to comment on the apparent change in sentiment by Treasury on this subject.

Further to the answers given in the hearing by Treasury officers, it is significant that the CLERP 9 commentary is **totally silent** on one of the most critical aspects of this entire issue, namely the availability and cost of PI insurance.

Accordingly, this oversight significantly diminishes the value and authority of the views expressed in the CLERP 9 discussion of the merits of PSL, and the weight that should be accorded to them.

As its main source of authority, it cites negative comments on the effect of PSL contained in a 1993 report by the MINCO Working Party looking at professional liability issues under the Corporations Law. This report criticised capping as a mechanism that placed professionals in a "privileged position" compared with other parties, and that shifted the risk of losses above the cap to the plaintiff.

The argument that capping of professional liability places professionals in a "privileged position" is false, as professionals are one of the few groups who face unlimited liability to the full extent of their personal assets for errors or mistakes made in the day to day performance of their occupations. Limiting their liability would place professionals on a more equal footing with most others involved in commercial conduct.

The issue of where the risk of liability above the cap should lie has been discussed above. The issue cannot be discussed in isolation from the crucial issue of the availability of insurance, for the risk of liability above a cap is no different to the risk of liability above insurance cover. The professions submit that without caps on liability, PI insurance will continue to become increasingly unaffordable and unavailable (and vital services that are regarded as high risk will continue to be withdrawn) leaving consumers of professional services to bear the risk of liability beyond (diminishing) insurance cover.

Whilst CLERP 9 failed to discuss the insurance implications of professional liability issues and the effect of PSL thereon, Treasury have since investigated these issues, and accordingly now support PSL for the reasons given in evidence.

The CLERP 9 discussion offers two further arguments against capping in the form of PSL.

The first is that, to be completely effective, PSL would need to be introduced in all jurisdictions. The paper considered this to be unlikely. Secondly, it noted that amendments would be needed to the Trade Practices Act (and as an aside, it does note that "To date most actions in respect of professional liability have combined an

allegation of a breach of section 52 of the Trade Practices Act and negligence at common law") and to the Corporations Act to give effect to PSL. Again, the discussion paper considered this unlikely.

Both of these reservations are now redundant. All States and Territories have agreed to introduce PSL and the Commonwealth is amending, via the Bill in question, the Trade Practices Act, the Corporations Act and the ASIC Act to give effect to State and Territory PSL.

Accordingly, we would submit that little weight should be given to the objections to PSL contained in the CLERP 9 discussion paper, which are either redundant or flawed due to their failure to address insurance issues.

ACCC Evidence on PSL

The Committee is referred to comments on the public record made by the Chairman of the ACCC in support of PSL.

On 14 August 2003, Commission Chairman Graeme Samuel stated in a speech to the Insurance Council of Australia:

> "Generally speaking, the Commission sees merit in professional standards legislation. Clearly, such schemes can offer benefits to consumers if they are constructed appropriately…. Properly constructed, professional standards (legislation) can raise consumers' knowledge of, and confidence in, the quality of professional services that they buy."

ACCC representatives in evidence to the Committee:

- Supported PSL's risk management component but questioned whether it was necessary to link these measures to liability caps;
- Asserted that caps shift risk from the person best able to manage the risk to the person least able to manage risk;
- Claimed that PSL provides incentives for inefficient levels of care by professionals;
- Asserted firms should be able to compete on liability by being able to contract out of caps.

The professions refute each of these arguments, which have been addressed in detail above.

PSL complements ACCC objectives to ensure and promote competition within a market. Professionals will continue to compete on service delivery, experience, quality and price, within a standard but flexible capping arrangement that can allow professionals to increase their maximum liability, should that be required, on a basis equal to any other professional within the scheme.

Further, the client will benefit from full disclosure of the liability cap applying to the professional, and best practice complaints and investigation procedures. It is noted that the ACCC submits that if caps are considered desirable, as a minimum caps should be disclosed to consumers. This is in fact already a requirement under all existing and draft PSL.

Professions would submit that the arguments put to the Committee in evidence by the ACCC fail to take proper account of cost and availability issues regarding PI insurance.

As mentioned above, policy makers and the community ought to be concerned by the prospect of commercial PI insurance disappearing completely. Legislative intervention in the market is needed to stop the withdrawal of insurance cover for professional services that are perceived to be higher risk. PI premiums are a serious

issue for professionals, but the greater problem is the unavailability of insurance and the increasing range of matters that are being excluded from and refused policy cover.

Without market intervention in the form of PSL, there must be real concern that PI insurance will not be available for many services and their providers in the future, to the risk of consumers of those services.