



ASSOCIATION OF CONSULTING
ENGINEERS AUSTRALIA

FINANCIAL SECTOR LEGISLATION AMENDMENT (DISCRETIONARY MUTUAL FUNDS AND DIRECT OFFSHORE FOREIGN INSURERS) BILL 2007

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Senate Standing Committee on Economics Inquiry

ACEA SUBMISSION

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The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

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INTRODUCTION

ABOUT THE ACEA

The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

There are over 250 firms, from large multidisciplinary corporations to small niche practices, across a range of engineering fields represented by ACEA with a total of some 29,000 employees.

ACEA presents a unified voice for the industry and supports the profession by upholding a professional code of ethics and enhancing the commercial environment in which firms operate through strong representation and influential lobbying activities. ACEA also supports members in all aspects of their business including risk management, contractual issues, professional indemnity insurance, occupational health and safety, procurement practices, workplace/industrial relations, client relations, marketing, education and business development.

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SUMMARY

ACEA is concerned about the impact of the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 (DOFI Bill) on the consulting engineering industry's ability to obtain adequate levels of PI insurance.

The impact of the insurance crisis in 2001/02 has meant that many consulting engineering firms must rely on the global insurance market in order to obtain adequate levels of PI insurance cover. Without such coverage firms would not be able to provide critical engineering and consulting services to their clients, including governments, industry and consumers.

The requirement for DOFI's to become authorised and regulated by APRA creates a trade barrier that many insurers may decline to cross, particularly for PI insurance, which is considered a higher risk category of general insurance. This has the potential to leave consulting engineering firms uninsured and in breach of contract with their clients.

Despite recent reforms including the introduction of Professional Standards Legislation and Proportionate Liability Legislation governments and private sector clients in Australia continue to demand high, and in some cases unnecessary, levels of PI insurance from consultants leaving them with no option other than to insure through DOFI's where there is greater capacity. This is an issue that impacts small, medium and large organisations alike.

ACEA is concerned that the proposal in the DOFI Bill will be detrimental for consumers because decreased competition from DOFIs coupled with the requirement to buy locally means that insurers are less likely to provide cover at commercially competitive rates or to insure an adequate range of risks, because they have a captive market. Even if local insurers do attempt to manage larger and more complex risks, previously insured overseas, they will look to spread that risk by increasing the cost of premiums.

SUMMARY RECOMMENDATIONS

1. ACEA recommends that the Bill be amended to reflect the preferred approach set out in the Potts Review, that is:

"Allow DOFIs marketing insurance in Australia to be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary."

2. If the DOFI Bill progresses unamended then Professional Indemnity Insurance must be exempt from the requirements in the Bill through the regulations.
3. ACEA also recommends that the issues surrounding the contractual behaviour of public and private sector clients and their understanding of risk must be addressed. The adoption of more appropriate risk management processes must be enforced in order to encourage the re-entry of Australian insurers back into the PI market.

THE OPERATION OF INSURANCE IN THE CONSULTING ENGINEERING INDUSTRY

A professional indemnity (PI) policy is designed to protect the personal or business assets of a professional from legal defence costs and charges incurred as a result of an actual or alleged breach of professional duty of care. In the commercial environment in which professional service providers operate PI insurance is essential. Clients in general require that a substantial amount of insurance be held by an professional service provider.

THE IMPACT OF THE INSURANCE CRISIS IN 2001/02

It is important to reflect on the impact of the 2001 global insurance crisis. In Australia this was triggered by the liquidation of HIH, a very significant insurer in the market providing PI insurance to consulting engineering firms. It resulted in the reduction of the number and capacity of PI insurance providers in Australia. For example, in 2002 QBE Insurance Group withdrew from the engineering PI insurance market.

The failure of HIH left consulting engineers bearing very significant legal costs and claims settlements. These liabilities were not mitigated by any government assistance. The subsequent withdrawal of Australian insurers from the PI insurance market for engineers and the selective withdrawal of PI insurance cover from individual firms by Australian insurers had a dramatic and in some cases severe impact on some firms in the industry.

The following case study taken from ACEA's report, "The Impact of Professional Indemnity Insurance in Consulting Engineering" dated July 2002 provides an illustration of the problems that faced firms at that time.

Firm Size:

Small firm employing 14 staff

Consultant Location:

Canberra ACT

Consultant Activity:

Electrical and mechanical consulting engineering

Issue:

A small firm with no claims notified over the last 10 years found major exclusions of 'heating and ventilation work' in the renewed PI insurance offer. This comprised at least 40% of the firm's work.

Action taken:

The firm renegotiated a revised policy with no exclusions with a different insurer, but with an increase of 500% in the premium and 50% increase in excess.

More broadly, the tightening of the market had the following impacts on the consulting engineering industry including:

- Increased premiums;
- Increased requirement for the insured to absorb the first level of loss (increased deductibles/excess);
- Restricted cover through revised or narrower policy wordings;

- More concentration on risk selection by insurers with a particular emphasis on lower risks with good claims experience;
- Restrictions on availability and;
- Increasing use of captive insurance vehicles.

A significant number of Australian consulting engineering firms then sought to obtain their PI insurance from the UK and USA and have remained offshore ever since. At the same time, many small firms providing services direct to consumers ceased trading or traded with reduced or no PI cover.

THE CONTRIBUTION OF OFFSHORE INSURERS

Since 2004 the PI insurance market has softened a little for consulting engineers with premiums levelling out, possibly in response to improvements in the equities markets and the increase in sophistication of risk management methods employed by consulting engineers. However, there have been no reports of any reduction in deductibles and ACEA members also report that there has been little change in policy wording.

The current situation is that the Australian PI insurance market either does not appear to offer the policy coverage or make it available to consulting engineers to protect their businesses at levels which are sustainable. Many Australian consulting engineers procure their PI insurance through the UK and US markets on terms which support both their domestic and international business effectively. It is fair to say that in this regard consulting engineering firms are sophisticated buyers of PI insurance.

ACEA member firms rely heavily on international PI insurance markets to provide cover adequate to protect their businesses. A review of the ACEA membership reveals a significant number of firms are obtaining insurance from offshore insurers including:

- 18% of small firms (employing 10 staff or less);
- 20% of medium firms (employing between 11 and 300 staff) and;
- 100% of large firms (employing 300+ staff).

Any reduction in access to the global insurance market will most particularly impact the small and medium businesses that do not have the benefit of global coverage. This is available to some of the large consulting firms whose off-shore parent organisations provide cover to all their international offices.

ACEA is very concerned about any action that might disturb or encumber the relationship consulting engineers have developed with international insurers. It is apposite to note that neither the consulting engineering industry nor their clients can afford a level of reliance on the local insurance industry as evidenced by the 2001/02 insurance crisis.

OPERATION OF PI INSURANCE IN THE DELIVERY OF ENGINEERING SERVICES

The consulting engineering industry is a major contributor to Australia's GDP. The industry services a broad client base, which includes:

- Major clients in the private sector and local, state and federal government - served predominantly by multidisciplinary medium and large firms and;
- Individual consumers in the community - served cost effectively by sole practitioners and specialist small firms.

Australia has been experiencing an unprecedented demand for services brought about by Australia's economic growth of recent years. This, and the increasing interest by governments in the development and upgrade of our infrastructure, has led to a dramatic increase in engineering construction project work.

ACEA member firms are contracted for projects ranging from (these are not exhaustive lists):

1. Large projects, including:
road and rail development; the design of bridges, dams and water storage facilities; airport development and upgrading; drainage, flood mitigation; power and water reticulation; urban development and public facilities including schools, hospitals, recreation centres;
2. To smaller projects, including:
environmental impact statements; pre-feasibility studies; and IT and software development.

PI insurance is an integral component in the delivery of these projects to clients. When a client selects a consultant the level of PI insurance that the consultant can access is often the deciding factor in whether or not the consultant is awarded the contract. The case study below records the experience of one medium sized consulting engineering firm that experienced this first hand:

A medium-size consulting engineering firm with over 30 years of experience, and a track record of award-winning bridge design, was the initial successful tender to a government client for a \$3 million bridge design project, for which the consultant's fee was \$50,000. The Professional Indemnity Insurance (PI) cover required by the client was \$20M.

The consultant had PI cover of \$15M. However, he was unable to secure the additional \$5M PI insurance cover required by the client at a reasonable commercial rate, or to negotiate a lower cover with the client. On this basis, although the consultant had initially been notified that he was the preferred tenderer, he was forced to withdraw from bidding for the project.

On protest, the client later agreed that for such a project their PI requirements were unreasonably high, and reduced their requirement to \$10M, a level which the consultant could easily have met.

However by this time the tender had been awarded to another consultant who had the \$20M cover (a major firm).

This case study highlights two issues:

1. The limited capacity of the Australian insurance market as a result of the insurance crisis (discussed above) and;
2. The demands by some clients for excessive and unnecessary levels of PI insurance.

CLIENT DEMANDS FOR EXCESSIVE LEVELS OF PI INSURANCE

ACEA members rely heavily on international insurance markets because of the:

- Diminished PI market in Australia following the insurance crisis in 2001/02 and;
- Levels of PI insurance that Australian clients demand leave little alternative but to obtain insurance from international markets with greater capacity.

The procurement practices of many clients guarantee that PI insurance cannot be obtained from the Australian market.

These clients favour contractual arrangements that transfer significant risk to the consulting engineer. This is often done by clients in an attempt to transfer their own risks and reduce their own insurance costs by demanding high PI insurance of their contractors and consultants under contract.

This is evidenced by those clients (including government clients) who through their contracts demand that the consultant 'contract out' of the Proportionate Liability Legislation. This legislation was introduced by the Commonwealth and all State Governments because it was recognised that,

*"The operation of insurance and the law of joint and several liability has given rise to professionals often being singled out as the sole target for legal action in proceedings for property damage and purely financial loss even when the professional is only one of the parties involved and may have only contributed in a minor way to the loss. These factors have led to an exponential increase in professional indemnity premiums which are not sustainable."*¹

By including a 'contracting out' provision clients are seeking to reduce their own exposure to liability by reintroducing joint and several liability into the contract. This is intended to make the professional consultant the primary target of claims, irrespective of responsibility for loss.

An example of one such 'contracting out' provision which is in use by a NSW government agency is:

"Part 4 of the Civil Liability Act 2002 (NSW) does not apply to this Agreement or any of the Services."

This transfer of risk to consultants is coupled with demands for excessive levels of PI insurance. ACEA receives frequent case studies from its membership highlighting this issue. The following case study concerns a contract received by an ACEA member in June 2007 with the work due to commence at the beginning of July 2007.

Firm size:

Incorporated company with a sole proprietor (owner/employee);

Consultant location:

NSW

Consultant activity:

Energy services

Issue:

A private sector company has asked the consultant to complete a greenhouse emissions reduction verification audit. The fee for this job is \$8,000. The contract that the client wishes the consultant to sign includes a requirement for the consultant to maintain \$10million PI cover.

Action:

The consultant has refused to sign the contract on the basis that the PI requirement is unnecessary and unreasonably excessive and also because of other contractual terms that transfer excessive risk and liabilities onto the consultant. The client has since agreed to withdraw their contract.

The transfer of excessive risks to consultants, which are outside their scope of responsibility or control, coupled with contractual terms that seek to reduce the statutory rights of the consultant make consulting engineering an unattractive risk for Australian insurers. While these contract practices continue to persist in

¹ In the Joint Communiqué issued 15 November 2002 from the Ministerial meeting on Public Liability insurance, Ministers issued the following statement.

the industry consulting engineers, be they large or small firms, will be compelled to seek insurance from markets outside Australia with greater capacity to spread and absorb their risk. If they are not able to do so it will have a significant detrimental impact on the delivery of critical engineering services in Australia.

IMPACT OF THE FINANCIAL SECTOR LEGISLATION AMENDMENT (DISCRETIONARY MUTUAL FUNDS AND DIRECT OFFSHORE FOREIGN INSURERS) BILL 2007

ACEA is concerned about the impact of the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 (DOFI Bill) on our member's ability to obtain adequate levels of PI insurance.

The DOFI Bill proposes that DOFIs that carry on insurance business in Australia or through the actions of another (i.e. insurance agent or broker) will have to become authorised under the Insurance Act if they wish to carry on insurance business in Australia. DOFI's will be required to comply with Australia's general insurance prudential standards.

ACEA believes that this requirement will act as a deterrent for DOFIs and that there is a high risk that many will choose not to seek authorisation. This will mean that ACEA member firms will not be able to access the global insurance market other than Lloyd's of London (which is provided a welcome exemption).

PI insurance operates on a claims made basis and is subject to annual renegotiation. Where a high value policy is required these may be packaged by brokers who can access the products of a number of underwriters. These larger policies, made up of layers, may change in their composition from year to year dependent on underwriters' capacity and other factors. Some underwriters may be registered with Lloyds others may not.

This change will have an almost immediate impact on our industry and could see many consulting engineering firms unable to source appropriate insurance cover, meaning that they will be unable to complete existing projects or continue work. This will put them in breach of their contractual terms with their clients which can lead to substantial legal costs.

ACEA also believes that this approach will adversely impact on those firms using the Australian insurance market. Decreased competition from DOFIs coupled with the requirement to buy locally means that insurers are less likely to provide cover at commercially competitive rates, or to insure an adequate range of risks because they have a captive market.

Even if local insurers do attempt to manage larger and more complex risks, previously insured overseas, they will look to spread that risk by increasing the cost of premiums.

ACEA is not persuaded that the approach proposed will operate to protect consumers. The DOFI Bill has instead the potential to significantly damage the consulting engineering industry, which will have an immediate effect on the delivery of engineering projects in Australia.

The proposal also appears contrary to Australia's approach to foreign trade, which is to reduce trade barriers rather than create them.

RECOMMENDATIONS

REGULATION

While ACEA would welcome the re-entry of Australian insurers back into the PI market, it must be achieved competitively and by providing products attractive to Australian businesses, not by creating a regulatory regime which favours local product.

ACEA recommends that the Bill be amended to protect the preferred approach set out in the Potts Review, that is:

Allow DOFIs marketing insurance in Australia to be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.

[This] would deal effectively with the foreign insurer issue without relying on a rigorous across-the-board approach which could be disruptive to a market already under strain. Enhanced information disclosure requirements would reduce the risks associated with foreign insurers from low status jurisdictions (the source of recent problems) but would stop short of the level of protection afforded by full prudential regulation.

REGULATORY EXEMPTION

If the DOFI Bill progresses unamended then Professional Indemnity insurance must be exempt from the requirements in the Bill through the regulations. This will ensure that small, medium and large consulting firms will continue to have access to the global insurance market.

ACEA believes that consulting engineering firms are well informed consumers of PI insurance, but to assist our firms ACEA has launched the 'PI Pathway'. The PI Pathway gives ACEA members access to the PI market through a panel of experienced and professional brokers. The ACEA Broker Panel offers members' comprehensive access to insurers and can also offer advice on price, coverage and services available.

The Broker Panel was chosen after a rigorous selection process. ACEA does not believe that its members, if using the PI Pathway will be exposed to poorly regulated or unscrupulous insurance providers. ACEA believes therefore that there is minimal risk in granting PI insurance an exemption under the regulations. Such an exemption will however ensure that the industry has access to the insurance required to deliver engineering and consulting services in Australia providing continued benefit from the healthy competition in the insurance market that derives from this.

BEHAVIOUR

ACEA also believes that the issues surrounding the contractual behaviour of public and private sector clients and their understanding of risk and adoption of more appropriate risk management processes, must be addressed in order to encourage the re-entry of Australian insurers back into the PI market. This can be achieved by committing to the following actions:

1. Adoption by all State and Territory Governments of nationally consistent Proportionate Liability Legislation that prohibits 'contracting out'.
2. Review of the wide range of policy-related web-based and hard copy publications currently in place across all levels of government, on procurement practice including Statements, Guidelines, Process Maps and Codes of Practice. These need to be repealed and/or regularised in favour of a nationally consistent approach to public sector procurement, leading to certainty not just for industry but also for government agencies. A whole of government approach and

endorsement through the Council of Australian Governments (COAG) may be the most appropriate forum to take this forward.

3. Adoption of a balanced approach to risk which is consistent with Abrahamson's Principles described in the 1990 "No Dispute" Report.

The Australian Procurement and Construction Council has developed Guidelines on the level of Professional Indemnity Insurance that may be appropriate to the services required from consultants in the building and construction industry. ACEA is aware that liability management guidelines are also being considered in order to assist contracting parties to consider agreement on appropriate levels of liability in contracts, reflecting value for money considerations. Guidelines should also be considered for risk management as part of the whole of government approach to procurement practices listed in recommendation 2 above.

4. Amendment of the Trade Practices Act 1974 to ensure that all Federal, State and Territory (including Local) Government procurement activities are covered by the Act in accordance with the Productivity Commission's recommendation in its Review of National Competition Policy 2005.
5. Actioning the recommendations proposed in the Regulation Taskforce Report, 'Rethinking Regulation' regarding an independent public review of the implementation of government procurement policies.
6. Introduction of legislation to ensure that clients refrain from incorporating terms in contracts which prejudice the ability of a consulting engineering firm, engaged by the contractor, to exercise independent professional judgement.

This can be achieved through the development of 'allowable and non-allowable matters' that may be included in consulting contracts. The 'allowable and non-allowable' matters in consulting contracts should be mandated through national legislation to ensure that they are observed.

This should be led by a whole of government taskforce, with the endorsement of COAG. The Australian Procurement and Construction Ministerial Council may best placed to take this forward. The Australian Procurement and Construction Council could lead this project with a team including expertise from the consulting engineering industry, insurers and legal advisors.

-Ends-