

Newsletter

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When is the premium you pay not the final premium - cover for new funds/mandates?

The Professional Indemnity insurance policy provides cover for investment advisory services provided in relation to 'Funds'. The policy definition of fund includes funds, trusts, mandates, any 3rd party agreement etc. All policies have different language, but all have similar intent.

Ensuring the Insurance company is aware of your funds is crucial:

- a) The number and size of funds contributes to the size of the premium; and
- b) The policy covers professional services in respect to the funds that the Insurer is aware of. If they have not been advised of a fund, then there may be no cover.

So, what happens if you have new funds during the course of the year - are you covered?

There are 3 possible policy responses:

- a) No cover
- b) 'Quasi' Automatic cover (i.e. its automatic cover that's not really automatic cover)
- c) Automatic cover

No cover:

Some insurance policies provide no automatic cover. This means you must immediately notify the Insurer of a new fund as soon as it comes on board. The Insurer must 'accept' the new fund and may charge additional premium for it. Failure to notify and get acceptance, will mean there is no cover for any claim in connection with that fund.

Quasi automatic cover:

The use of 'quasi' is my word - the catch is that policies say 'automatic cover' but in fact it's only partially automatic. Typically the cover is only automatic for 60 or 90 days, then you have to notify to get cover, and the Insurer must 'accept' the new fund and may charge additional premium for it. Failure to notify and get acceptance after that 60 or 90 days period, will mean there is no cover for claim in connection with that fund.

Automatic cover

The policy will cover any new fund during the policy period for no additional premium. Even this may have limitations. It might say that the cover is only fully automatic provided that the fund is less than \$xm in size, not a Hedge Fund, Agricultural Fund, US Based etc, or even materially different from any previous funds. Nevertheless, it will provide automatic cover for those that fit within the defined parameters.

The key is to be aware of what type of cover you have. A business that is going through a growth phase needs to consider this clause specifically, because otherwise you may end up paying far more premium throughout the year than you expected/budgeted.

What is the right policy limit to buy?

I get asked this question frequently – how much cover should we buy? When deciding what limit of indemnity to purchase, there are a range of factors to consider which influence the source of claim and/or quantum of claim. Some of the factors that I consider for my clients include:

- Legal requirement. As a first step, what is the minimum limit required by law as an AFSL holder.
- Size of FUM. The larger the FUM then theoretically the more money can be 'lost', which has an impact on size of claim.
- Number of mandates. The more clients/mandates the more exposure.
- Complexity of mandate. The more complex the mandate the more likely there could be a breach
- Quality of compliance program to manage conflicts of interest, especially as the business grows
- The nature of the investment profile. Is there is inherent volatility in the investment mix?
- Use of leverage and gearing. Can exacerbate the size of loss.
- Use of derivatives. The greater the use of complex instruments, the greater the chance of an error.
- Type of investor - retail or wholesale. There is a belief that retail exposure is higher on the basis that they are less aware of how things work, and therefore more likely to allege they have been misled.
- Overseas exposure: In particular overseas investors (e.g. US) can increase exposure to claims
- Use of custodian. A reputable custodian in place reduces exposure from fraud and other compliance errors.
- Lifecycle of the business. Companies going through growth phase may be at risk, because resources can't keep pace with growth, and errors can occur.

- Staff: the number of staff (sufficient to manage workload, especially as business grows), quality of staff (the more experienced the better), longevity of staff (turnover may be an indicator of issues).
- Regulatory issues. There may be industry wide issues that impact the risk profile of client.
- Financial standing of entity. Businesses losing money may take more risks to generate cash flow to 'save the business'.
- Culture. This is crucial. A business can have all the compliance processes and procedures in place, but if there is a culture of 'getting the job done' irrespective of compliance and risk management, then the likelihood of a claim increases.
- Transparency. The more transparent the operations and performance of the business, the less likelihood that errors will remain undetected and increase.
- Premium cost. Ultimately, the value in purchasing additional limit of indemnity needs to be weighed up against the additional premium cost to purchase the limit.

Sitting with your Broker to work your way through some of these factors can assist in the discussion on limit of indemnity.

How does a Broker earn money?

Brokers earn money in a variety of ways, which can include one, some or all of the following:

- a) Commission on premium. The Insurer charges a premium of \$100 plus charges. You, as a client pay \$100 plus charges. The Insurer receives \$85 plus charges. The Broker earns \$15 plus charges. Typically commission is 15%, but can be 20% or more.
- b) Professional Fee. The Broker charges a fee for their services. Unless the Broker is earning both fee and commission, they will typically 'nett' the premium and charge fee. In example above, the Insurer would charge a premium of \$85 plus charges (nett) and the Broker would charge a fee of, for example, \$15 plus charges.
- c) Interest on premium. A Broker collects premium for payment to the insurance company. By law a Broker can hold premium for up to 90 days from policy inception before they have to pay the Insurer. The Broker can earn investment income on this premium they are holding. So, if your renewal is 30 June 2010, and you pay the premium 1 July 2010, the Broker can hold the premium, and earn interest income, up until 30 September 2010.
- d) Premium funding. Premium funding is an effective way for clients to smooth their repayments. In essence, the premium funder pays the Insurer upfront, and then the client enters a contract to repay the premium funder in instalments. There is obviously an interest cost to this funding

mechanism. A Broker can choose to earn a small commission to arrange the contract - its payable by the premium funder, but ultimately it's the client who pays it.

- e) Profit share. Under some arrangements between Insurers and Brokers (typically under a Binder arrangement i.e. where the Broker has authority of Insurer to place business – acting as agent of Insurer not the client), a profitable underwriting result can lead to a profit share back to the Broker. This is not common for Investment Managers.
- f) Contingent commission. This can go by a variety of names, and is effectively banned, although there are legal variations still in practice. In essence, a broker earns more commission from a specific Insurer when they place more business with that Insurer. The Insurer is encouraging/rewarding a key distribution channel. The criticism is that the decision to place the business with that Insurer may have been compromised by the potential to earn additional income i.e. 'was it in best interest of client'? One counter to this criticism is that placing volume with a particular Insurer can enable the Broker to leverage a better deal for their clients as whole.
- g) Commissions on overseas placements. Some Brokers place business into the London market – this is typically not done direct between Australian Broker and London Insurers – instead it is done via a London Broker (or London Branch/operation of the Australian Broker). The London Broker may earn additional commission above and beyond whatever the local Broker earns.
- h) Overriders to cluster group. Many Brokers a part of a cluster group (effectively purchase power groups and representatives). These cluster groups can earn additional commission from an Insurer for any business placed by their members. This override is then 'put back' to the members as a whole for various purposes (education, training etc). This is not income direct to the individual Broker per se, but certainly to their advantage as a group.

At end of the day, it may not really matter how a Broker earns money so long as:

- a) Transparency: as a client you know exactly what is being earned by the Broker; and
- b) Represents value: it is fair and reasonable and represents good value - be it that the coverage has been improved beyond the standard form and/or the premium has outperformed the market cycle and/or the Broker service is superior.