PROFESSIONAL INDEMNITY INSURANCE
BUYER'S GUIDE FOR FINANCIAL ADVISERS

howden
windsor

FOREWORD

MOST FINANCIAL ADVISERS NEED PI COVER AND OBTAINING GOOD TERMS AT A FAIR PRICE HAS LONG BEEN A CHALLENGE. THE CURRENT ECONOMIC SITUATION AND A HOST OF OTHER FACTORS HAVE EXACERBATED THE SITUATION, IMPACTING ON BOTH THE AVAILABILITY AND COST OF PII FOR ADVISORY BUSINESSES. I AM DELIGHTED THAT HOWDEN WINDSOR AGREED TO PRODUCE THIS BUYERS GUIDE, WHICH PROVIDES VALUABLE INFORMATION AND ADVICE THAT WILL HELP PFS MEMBERS SECURE THE RIGHT POLICY FOR THE BEST PRICE.

Fay Goddard, Chief Executive
The Personal Finance Society

PFS

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OVERVIEW

The Professional Indemnity Insurance (PII) market for Financial Advisers in the UK has not been the calmest in recent years and most firms have noticed a considerable hardening of the market. This means that many Financial Advisers have been facing increased premiums, excesses and exclusions which have had a negative impact on the way their firm operates.

The state of the economy in general, coupled with the previous downturn of investment returns, has created certain concerns for insurers with many ceasing to write PII to cover financial advice altogether and others offering policies with newly imposed restrictions and exclusions. Where insurers have withdrawn from the market, this has forced their policyholders to move to another insurer, creating further uncertainty and lengthy renewal proposal forms becoming the norm.

Issues with financial institutions and funds becoming insolvent, failed or suspended such as in the case of Lehmans, Arch Cru, Brandeaux and Keydata have had a major influence on the PII market. This has affected all advisers, even those that have performed well and stayed away from the various problem areas, as the level of claims has impacted the entire market putting pressure on insurers to increase PII premiums.

As we enter the newly redefined financial services arena with "Restricted" and "Independent" categories of Financial Adviser courtesy of the Retail Distribution Review, PII, specifically its availability and cover afforded, is once again a hot topic. We hope you find this guide to be of valuable assistance to your business in understanding what considerations you should make when buying Professional Indemnity Insurance.

PII REQUIREMENTS FOR FINANCIAL ADVISERS

PII is liability insurance that covers businesses in the event that a third party claims to have suffered a loss as a result of professional negligence. The FSA requires that all firms must carry a specified minimum level of indemnity for both a single claim and aggregate claims per year.

For firms that fall under the Insurance Mediation Directive (IMD), the minimum levels are set out in Euros and are as follows;

- €1,120,200 each and every claim and
- €1,680,000 for claims in the aggregate

For UK based firms, these minimum requirements are translated into Sterling and must be met at the date of taking out the policy and at the date of renewal. Firms are required to have continuous cover from the date of their authorisation.

As PII policies are written on a "Claims Made" basis, the policy will only cover claims notified during the policy period, regardless of when the work was undertaken. The FSA requires that a policy must offer fully retroactive cover all the way back to the authorisation date. If a retroactive date is specified, it is important that this meets all your cover requirements and does not expose you to an uninsured period.

Unlike other professions there is no standard or minimum wordings and as a result there are varying levels of coverage offered in the PII market.

There are additional capital adequacy requirements if you have an excess of over £5,000 or if you have any exclusions in your policy for activities that your firm is or has been involved in. Please see http://fsahandbook.info/FSA/html/handbook/MIPRU/3/2 for further information including tables that set out the additional capital requirements.

For those firms that "passport" their services and have to meet the PII requirements of the Markets in Financial Instruments Directive (MIFID), there are further requirements regarding the limit of indemnity or capital adequacy that you must carry – Please see http://www.fsa.gov.uk/pubs/forms/passporting_factsheet.pdf for further information.

CONSIDERATIONS FOR INSURERS

Although individual firms cannot control the general state of the PII market, there are several factors to consider as insurers offer terms on a bespoke basis which reflect the individual exposure of each firm.

Total Commission/Fee Income – The amount of gross commission/fee income is one of the clearest signs as to how much business the firm transacts and therefore best reflects the exposure to insurers. Insurers look for how the firm has performed in the last few years as well as the estimated income for the current or next financial year and will query any unusual spikes, or drops in turnover. A steadily growing firm or a firm with a fairly consistent level of turnover is usual but a sharp drop or hike may be a sign of an underlying issue within a firm. Of course a blip in turnover is not always an issue so if your income does show unusual activity you should provide a brief narrative to explain why.

Business Split – Some activities that a firm conducts are deemed to be higher risk than others and are therefore rated accordingly by insurers. If two firms have a similar turnover but one focuses on higher risk investments (e.g. tax mitigating products, unregulated collective investment schemes) and the other on lower risk investments (e.g. ISAs and Unit Trusts) then it is likely that the former firm will have to pay a higher premium. Alternatively insurers may impose a higher excess to those products or exclude them from cover altogether. That is not to say that the higher risk areas should not be conducted or should necessarily be a problem to cover but firms conducting these activities need to be able to provide sufficient information and supporting documentation on how they advise their clients in these areas, what risk management they undertake and the procedures they adhere to.

Complaints and Claims History - Claims are sometimes inevitable, especially in the current climate. Insurers will want to know the nature of any circumstances that may give rise to a claim and how they came about. Any measures taken to prevent a recurrence of the situation, changes to procedures that may have been implemented, such as internal reviews and introducing sign-offs, are all steps that will be well received by insurers.

Client Documentation – Insurers may require sight of the standard documentation that a firm uses, such as engagement letters, terms of business, fact finds and reports. These documents can help show how well defined your services and audit processes are and whether they can be relied upon to help defend a claim.

Compliance – The insurer will consider the internal compliance functions within a firm. Your position may be further strengthened if you have an external compliance provider who conducts regular reviews on your business.

Personnel – Quality of the firm's personnel is considered and experience, qualifications and training are all very important. If a firm is part of a quality group or network or in particular, the firm holds Chartered status, then this will also be viewed positively as it normally indicates a higher set of standards.

Once the underwriter has settled on a rate, after taking into consideration the rest of the underwriting factors, they will apply this to the total income. This normally means that the larger the income, the larger the premium, although size discounts are usually available.

COMPLETING THE PROPOSAL FORM

Completing your proposal form can be something of a challenge. Many of the short forms that have appeared from time-to-time have been replaced by lengthy forms asking for detailed information from over a ten year period and sometimes even further back.

As financial advice concerns have risen, insurers have requested more and more detailed information in order to help correctly identify all areas of risk that a firm may pose. The forms will ask for lists of products, investment values, percentage of holdings in clients' portfolios and supporting documentation. It is appreciated that these questions can be difficult to answer, but the disclosure of accurate information is vital. In order to ensure cover is not invalidated there must be an accurate disclosure which would ensure that the insurer is aware of everything that is material including any proposed change in future activities.

TOP TIPS SURROUNDING THE BUYING PROCESS

- Start the process early. Proposal forms are increasingly complex and brokers may require longer to negotiate with insurers. If your broker has not contacted you eight weeks ahead of renewal chase them or ask another broker to provide a quotation.

- Ensure the proposal form is neatly completed and accurately represents your business. If you fail to declare any activity that you have transacted previously, insurers may avoid claims, or even worse, void your policy from inception. If you feel that you need to clarify your answers on the proposal form then include additional notes on your own letter-headed paper.

- If your firm has operated in traditionally high risk areas e.g. UCIS or tax mitigation products, be prepared to release comprehensive data including products sold, original investment amounts, current values and a percentage that this investment represents of the client's overall portfolio and provide supporting documentation.

- Ensure your broker understands what risk management measures your firm has in place as this will allow your insurer to differentiate your firm from those which take a less disciplined approach. Areas to highlight could include compliance procedures, a review of the systems that you have in place and a copy of documentation provided to clients.

- If you have had claims or notifications, provide as much information to your broker as possible including date of notification, amount claimed, a brief summary of the work undertaken, and the alleged wrong doing, accompanied by solicitors' reports on any claims paid. It is always very important to provide reassurance to insurers that there will not be a reoccurrence and that there is not a systemic issue, so be prepared to provide details of any steps that have been taken to prevent the same problem reoccurring.

- Ensure the brokers you are using are experienced and have a long history in placing PII for Financial Advisers. Ask for the names of the insurers that they will approach and whether they have a proven track record in this market. Asking multiple non-specialist brokers to quote could make the process unnecessarily complicated and it can discourage insurers from quoting.

- Ensure that you have your quotations well before your renewal date, especially if you are moving insurer. You need to familiarise yourself with all the terms and conditions before your policy incepts and ask your broker to explain any condition of which you are unsure.

- Ensure the person in charge of buying insurance understands the business and appreciates how to run an efficient buying process.

- Whilst price is important, ensure your broker and insurer have a strong and experienced claims team to provide you with assistance should you have a notification. Ask about the experience the insurer and broker have in dealing with Financial Advisers and the scope of coverage that they are able to offer. Wordings between insurers can vary a great deal and there are a number of key features that directly relate to the financial services industry which you should look for.

IMPORTANT FEATURES TO LOOK FOR IN A PII POLICY

What level of coverage do you have? The narrowest form of coverage is for negligence that only covers any claims that arise

Are there any exclusions for any of the activities that you conduct? If there are any exclusions for work that you intend to do or have undertaken in the past this will leave your firm exposed should a claim arise. You may also be required to carry additional capital as set out by the FSA.

Are Defence Costs payable in addition to the Limit of Indemnity? This is the best form of cover. If you see that Defence Costs are included in the Limit of Indemnity this will actually reduce the sum available to settle any claims.

Are Defence Costs subject to any Excess? If you see Defence Costs applicable to the Excess, insurers can appoint solicitors to defend you but you will be responsible for the excess applicable.

Does the policy have an Insolvency or Failed Fund Exclusion? This type of exclusion is present in numerous policies and can exclude claims that arise from the failure of a financial institution or suspended fund such as Keydata, Brandeaux and Arch Cru. The extent of these exclusions can vary greatly and some policies do not contain this exclusion as standard. Sometimes this exclusion can be in the wording itself rather than highlighted by endorsement.

Does the policy allow Inadvertent Non-Disclosure protection? This is where insurers will not exercise their right to avoid the policy in the event of a material non-disclosure, misrepresentation of facts or untrue statement. It has to be demonstrated to insurers that such inadvertent non-disclosure, misrepresentation or untrue statement was innocent and free of any fraudulent conduct or intent to deceive.

Is there an extended reporting period for claims/ circumstances? This is a clause whereby insurers will accept notice of circumstances during a limited period of time after expiry of the policy, provided always that the matter being notified first came to your attention during the Period of the policy.

BE AWARE

The most important rule is to be sure that you are fully aware of what you are buying. That is to say that you should be completely clear as to what is, and is not, being covered. You should also be aware of the implications this has to your business. Ensure that your limit of indemnity is adequate and meets all the FSA requirements. If you are being offered higher excesses for certain lines of work, make sure that you are fully aware of the implications on capital adequacy and your exposure, should you have any claims in these areas. Likewise, be aware of exclusions as these should be shown and explained in your policy. It is the unfortunate truth that many policies, as good as they seem on the face of it, contain exclusions and features, that the buyer is not necessarily aware of, within the wording rather than being specifically endorsed and highlighted. It is normally only when there is a claim that this is realised, and then of course, it is too late.

KNOW YOUR INSURER AND BROKER

You should ensure that you are happy with the solvency and strength of your insurer by looking at their financial rating and any additional backing they may have. Details can normally be found on the insurer's website and your broker should be able to assist you with your enquiries. In addition, look at their experience and knowledge of the Financial Services market. A long standing insurer with a large book of Financial Advisers may have more expertise and a stronger, more experienced claims department. This would equally apply to your choice of broker as one who can demonstrate a stronger understanding of the Financial Services market is likely to be more effective in dealing with any placement issues or claims when they arise and be able to offer their clients a more bespoke service. You should be aware of what insurers your broker has access to as some use a range of selected insurers whilst others have exclusive schemes.

RISK MANAGEMENT

Having a strong internal risk management system in place can protect you from a successful claim as it puts you in a stronger position to defend it. Insurers look favorably on a strong system. Below are some key areas to look at:

- Have an appropriate, well documented compliance policy in respect of your advisory and sales process in all areas of your business.
- Maintain a Risk Register and have systems of control in place to manage risks.
- Ensure all clients sign a Terms of Business agreement together with a letter setting out the scope of the services provided by your practice.
- Have systems in place to ensure that key dates are controlled and backed up. A high quality diary system should be in place for all staff.
- Ensure that a good proportion of post sale activity is reviewed, especially in higher risk categories.
- Minimise and have controls against conflicts of interest.
- Ensure there are supervisory controls in place that also extend to all Partners/Directors.
- Ensure staff are qualified for the work they do and appraised regularly.
- Ensure instructions from clients are evidenced in writing.
- Where you have a complaint ensure that you have systems in place to go back through the process to identify if there are any weaknesses or training requirements.

"CLAIMS MADE" BASIS OF PII COVER

In the UK, PII policies are always written on a "Claims Made" basis. This means that the policy only covers claims made during the period of the policy, irrespective of when the act, error or omission alleged to have given rise to the claim was actually committed or occasioned. In other words, it is the policy in force when the claim/circumstance is first notified by the insured to the insurer which will cover the claim under the policy, rather than the policy in force at the time the actual act, error or omission was made.

It is absolutely essential that a claim is notified to insurers as soon as possible after it is known and is notified in full compliance with the claims notification provisions of the policy. These vary from insurer to insurer. Whilst these provisions are all intended to have a similar effect, the wording of each of them differs and it is in the insured's best interest to have read and fully understood what is required of them in these circumstances.

Some claims conditions are Conditions Precedent to Liability. A Condition Precedent must be complied with unconditionally and absolutely. If it is not, the policy can be voided "ab initio" and therefore there will be no insurance protection offered by the policy. All staff should be aware of the notification requirements of their own firm's PII policy.

NOTIFICATION OF PII CLAIMS AND CIRCUMSTANCES

There can be some confusion over what actually constitutes a claim or circumstance. A "circumstance" is an occurrence that "might/could/may/is likely" to give rise to a claim. The words "might/could/may/is likely to" are variously used by different insurers and have different practical meanings but there is no uniformity of practice in the PII market.

Every Financial Adviser needs a clearly defined procedure for identifying, assessing and controlling claims and circumstances that may give rise to a claim. The procedure must be able to detect and identify potential claims and circumstances as early as possible. It must also determine exactly when and how the matter is reported to insurers and what details must be included in that report. This is essential. If it fails to achieve this, the firm may be left exposed.

Why is it important?

Firstly, the earlier a problem is identified and brought under control, the greater the chance of minimising its impact and cost will be. Secondly, insurers insist upon prompt notification and reporting to avoid being prejudiced by the actions of the insured who tries to take the matter into their own hands. Issues arise when the insured believes that a notification will not go anywhere or where they believe that they can "do a deal" with the claimant. If the matter escalates, then by trying to do so they have caused prejudice to the insurer, thus entitling the insurers to avoid dealing with the claim.

When should you notify claims?

As soon as possible after you become aware of the issue. All PII requires the insured to give notice as soon as possible of any claim or circumstance which "may/might/could/is likely" to give rise to a claim; the expressions differ from policy to policy but the intent is similar. Some policies may even state a specific number of days in which any claim or circumstance must be notified after you become aware. Failure to do so can nullify the policy cover.

What should you report?

As a rule of thumb, if you have to ask yourself whether a matter should be reported, it probably should be. Insurers would rather see you as proactive than reactive.

You should report:

- Any actual allegation or claim made against you, whether spoken or in writing.
- Any suggestion, intimation or indication that a claim against you is being considered; however remote you believe this to be.
- Any circumstance, situation or problem that you recognise to be a potential issue for you, your client or any third party with whom you are dealing, which could result in dissatisfaction, a complaint or refusal to pay fees or other monies.

What about claims which fall within the excess?

All claims should be reported, even those which are likely to fall within your excess. Failure to do so can invalidate the policy.

Will this affect the premium?

Claims could affect the premium but this will always depend on the facts. If it is too early to tell then you be given the benefit of the doubt but if there has been a particularly large payment then you can expect an increased rate. If you can demonstrate that you have taken measures to prevent this reoccurring then this will help mitigate any increase in your premium.
Never allow your potential increase in premium to influence your decision as to whether to notify. The cost of defending a claim can often greatly outweigh the increase in premium, even in cases where you do not expect it to. If you are still in any doubt contact your broker or seek legal advice.

HOW CLAIMS ARISE

Until comparatively recently, most claims against IFAs came about because firms omitted to process documents (such as lodge surrender documents) and instructions correctly, or filled in application/surrender forms on behalf of clients who then denied their content either because they had forgotten what they said or the adviser recorded something incorrectly.

Now compliance is much more diligent and simple procedural errors are usually avoided, claims appear not to arise so frequently from basic errors but due to either not understanding the product properly or not correctly categorising/adhering to the correct risk profile. The adviser is now under greater pressure to fully understand what they are arranging and to ensure that not only the right customers receive the right product but also that they comprehend the risks in what they are getting. The three examples below help serve to illustrate this:

EXAMPLE ONE

The client wished to repatriate £1m part of £7m offshore bonds to invest in a business opportunity. The insured calculated Capital Gains Tax (CGT) on £1m as being circa £150k which was accepted by the clients as worthwhile. HMRC, however, deemed tax was payable on the whole amount which totaled CGT of £2.3m. It was accepted the funds would, at some stage, come onshore and a mediated settlement of £565k CGT was negotiated.

Moral of the story: Check areas outside your knowledge, such as tax, with a tax expert.

EXAMPLE TWO

A number of clients arranged life/protection policies to go alongside mortgages in joint names. When one half of the couple died, unmarried to the other, the proceeds went to an estranged parent (or other relative) under inheritance laws, leaving the survivor bereaved and without the benefit of the insurance. A claim for £150k was successfully made against an adviser for failing to arrange the policy as instructed.

Moral of the story: Ensure you know your client and the cover does what it is designed to do.

EXAMPLE THREE

The insured advised clients to invest in unregulated property investments. The insured failed to identify the fact that they were geared investments. When the developments dropped in value the lending bank forced the sale of certain properties to recoup their losses as they had first call on funds. There was insufficient money left over for investors. £1.6m loss (the policy limit) was paid by insurers.

Moral of the story: Undertake due diligence and only sell products you understand fully.

RUN OFF COVER

Unlike some other professions, there are no mandatory requirements for financial advisers to take out run off cover when they retire or sell their business. Run off cover is a form of PII policy that offers cover for a firm after they cease to write business (e.g. due to the firm ceasing to trade or selling the firm without previous liabilities to a new owner). Whilst not a mandatory requirement, it is recommended that run off cover is purchased and we refer you to the Limitation Section on the next page where you can gain insight into the extent of your exposure. Many firms recognise that, because a PII policy is on a "claims made" basis, it is wise to buy a policy to cover them (and their clients) should a claim/loss arise.

Advisers can remain vulnerable to complaints about advice given any number of years ago and it is up to them to assess how long they should maintain cover. Premiums are normally set at the level of the last annual premium you paid for the first year's run off and you should expect a reduction every year, subject to market conditions and claims history.

Further issues arise where an insurer ceases to write Financial Adviser PII business. Firms that have maintained run off cover and learn that their insurer is no longer writing this class of business can find it extremely difficult to source a replacement. Some insurers are willing to offer terms on a case by case basis, but, alternative providers can be difficult to find.

In addition, coverage is usually only available on an annually renewed basis rather than a single block policy to cover you for a longer period.

If you are selling your business then the buyer may want to exclude taking on responsibility for any claims arising from advice given prior to the date of the sale. This, however, is not always the case so, if you are selling your business or client bank, ensure that the previous liabilities of the firm are discussed and agreed on. You will then be in a position to consider purchasing appropriate cover.

LIMITATION

There are a number of different limitation periods for claims, depending on the type of claim. The standard limitation period is six years from the breach. In claims against professionals, the date of breach will generally be the date of the alleged negligence. For claims against Financial Advisers, it is the date of the completion of the defective transaction, for example the investment (s.2 Limitation Act 1980).

There is a "carve out" from the above position where the negligence is not known about by the non-breaching party. In that case, the limitation period is three years from the date on which the complainant learned of (or should have known of the probability that there had been) the negligence/ a loss (s.14A Limitation Act, introduced by the Latent Damage Act 1986). This is subject to a long-stop limitation period of 15 years from the negligent act/omission.

For claims where fraud is involved, where the breaching party has deliberately concealed the error, or there has been a mistake (in the legal sense), the limitation period is extended to six years from the date upon which the complainant could reasonably have discovered the fraud, error or mistake and there is not the 15 year long-stop (s.32 Limitation Act 1980).

The jurisdiction of the Financial Ombudsman Service (FOS) is subject to the same limitation periods in that the claim should be brought within either the six year rule (as per s.2 Limitation Act) or the three year rule relating to negligence/loss only reasonably discoverable subsequently (as per s.14A Limitation Act). Importantly for the three year rule, there is no 15 year long-stop for claims to FOS. However, FOS has an additional time limitation in that it will not hear claims unless brought within six months of the final rejection of the complaint by the relevant business.

ABOUT HOWDEN WINDSOR

Howden Windsor is the specialist Professional Indemnity Insurance division of Howden Insurance Brokers. With a team of over 100, we are responsible for placing PII on behalf of over 20,000 clients.

We have a long association with the financial services sector and have worked through many challenging market environments to strive to provide continuity of coverage on the broadest possible terms available to our clients. We are proud to maintain one of the UK's largest in-house Professional Indemnity claims handling teams with over 30 members of staff on hand to act as your advocate and adviser in the event of a notification or claim.

Our Professional Indemnity division has grown significantly in recent years following the acquisition Windsor Partners in 2012, building one of the largest PII divisions in the London market. Howden Insurance Brokers Limited is the Lloyd's registered, London-based broker of the Howden Broking Group.

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