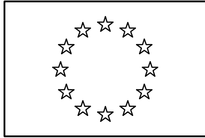

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.4.2007
COM(2007) 178 final

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Final report of the European Commission on the continued appropriateness of the requirements for professional indemnity insurance imposed on intermediaries under Community law

TABLE OF CONTENTS

1. PII requirements for intermediaries under community law 3
1.1. Article 4 of the IMD... 4
1.2. Articles 7 and 8 of the re-cast CAD 5
1.3. Historical background 6
2. Policy rationale for PII requirements 7
2.1. Consumer protection 7
2.2. Advantages to service providers and markets 7
2.3. Arguments against PII requirements.. 8
3. Targeted Consultation with Member States and Competent Authorities..................... 8
4. Public consultation on the Draft Report.. 9
4.1. Results of the consultation 9
5. Conclusions 10

INTRODUCTION

The Commission is required by Article 65(6) of Directive 2004/39/EC on markets in financial instruments ('MiFID') to report to the European Parliament and Council on the continued appropriateness of the requirements for professional indemnity insurance ('PII') that are currently imposed on intermediaries under Community law.

1. PII REQUIREMENTS FOR INTERMEDIARIES UNDER COMMUNITY LAW

Professional indemnity insurance is a liability insurance designed to cover, either entirely or in part, sums to be paid by professionals, either as damages or resulting from approved negotiated settlements, to third parties as compensation for losses arising from acts, errors or omissions committed by the professional during the conduct of its business activities.

Community law requires some investment and all insurance intermediaries to obtain such insurance as a precondition to be able to provide services. The relevant requirements are derived from two Directives:

- Directive 2002/92/EC on insurance intermediation ('IMD')
- Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (re-cast)[1] ('the re-cast CAD')

The following sections set out in detail the PII requirements under these two directives.

1 The provisions in question are derived from new paragraph (4b) of Article 3 of Directive 93/6/EC, inserted by Article 67 of MiFID).

Summary of PII and capital requirements for different types of intermediaries

Insurance intermediary	Investment intermediary	Investment intermediary which is also an insurance intermediary
PII covering the whole territory of the Community with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year.	One of the following: (a) initial capital of EUR 50,000; (b) PII covering the whole territory of the Community, or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year; (c) a combination of initial capital and PII in a form resulting in a level of coverage equivalent to (a) or (b).	PII covering the whole territory of the Community with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year. + One of the following: (a) initial capital of EUR 25,000; (b) PII covering the whole territory of the Community or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 500,000 for a single claim and, in aggregate, EUR 750,000; (c) a combination of initial capital and PII in a form resulting in a level of coverage equivalent to (a) or (b).

1.1. Article 4 of the IMD

Article 4.3 of the IMD sets a minimum limit of indemnity for both an individual claim and claims in aggregate.

All insurance intermediaries are required to hold PII covering the whole territory of the Community, or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year (unless such insurance or comparable guarantee is already provided by an insurance undertaking, reinsurance undertaking or other undertaking on whose behalf the insurance or reinsurance intermediary is acting or for which the insurance or reinsurance intermediary is empowered to act or such undertaking has taken on full responsibility for the intermediary's actions).

An intermediary, regardless of its size and irrespective of whether it actually operates in more than one Member State, must satisfy this requirement in order to be registered and to carry on insurance intermediation in the EU. However, the requirements are minimum limits of cover so Member States may add additional requirements under national law. There are no provisions in the IMD permitting Member States to exempt firms from the requirement to hold PII (other than where a firm holds a 'comparable guarantee'): in particular, capital resources are not permitted as an alternative to PII.

1.2. Articles 7 and 8 of the re-cast CAD

Among a series of provisions requiring investment firms as defined in Article 4.1(1) MiFID to hold varying levels of initial capital, Articles 7 and 8 of the re-cast CAD impose requirements relating to PII or initial capital on investment firms which are authorised under MiFID only to provide investment advice or to receive or transmit orders from investors, without also holding client assets ('MiFID intermediaries'). These firms are excluded from the requirements relating to initial capital that apply to investment firms generally under Articles 5 or 9 of the re-cast CAD, and the capital requirements imposed upon them are significantly lower because they are supplemented by PII requirements that do not apply to other investment firms.

Article 7 applies to MiFID intermediaries that do not also carry on the business of insurance intermediation. Such firms are required to have one of the following:

(a) initial capital of EUR 50,000;

(b) professional indemnity insurance covering the whole territory of the Community, or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year;

(c) a combination of initial capital and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).

The PII requirements under paragraph (b) are, of course, identical to those imposed upon insurance intermediaries under the IMD. However, the re-cast CAD confers greater flexibility: a choice between initial capital, PII, or a combination of the two.

Article 8 applies to MiFID intermediaries which are also registered under the IMD as insurance intermediaries. In addition to complying with the PII requirements of Article 4.3 of the IMD, such firms must have one of the following:

(a) initial capital of EUR 25,000;

(b) professional indemnity insurance covering the whole territory of the Community or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 500,000 for a single claim and, in aggregate, EUR 750,000;

(c) a combination of initial capital and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).

The deadline for the transposition of these requirements has not yet expired, so investment firms are not currently subject to any PII requirements under Community Law. They may, however, be subject to comparable requirements under national law, and any observations based on the impact of analogous national requirements will therefore be relevant to this draft

Report. Like the IMD, the re-cast CAD permits Member States to impose rules that are stricter than those required in the Directive.[2]

1.3. Historical background

As indicated above, the PII requirements that apply to insurance intermediaries under the IMD differ from the requirements that apply to MiFID intermediaries under the re-cast CAD. The IMD requires all insurance intermediaries to hold PII with a specified minimum cover for liability for claims arising from professional negligence whereas the MiFID intermediaries are subject to a regime which allows a combination of PII and minimum capital.

The Commission's initial proposal for the Directive that became MiFID[3] had required firms that provide investment advice or services of reception and transmission of orders for clients, but which do not hold client money or securities, to hold PII with a cover equal to that required under the IMD for insurance intermediaries, without any option to satisfy capital requirements as an alternative. However, during the Council negotiations some Member States raised concerns. Those concerns were two-fold:

- market changes might reduce the availability of PII to investment advisors; and
- the proposals might impose excessive burdens on firms carrying out both investor advice and insurance mediation.

Accordingly, the Commission proposal was modified by the co-legislators. First, greater flexibility was introduced, by permitting firms either to hold the specified level of PII, or a specified minimum capital, or a combination of both. Secondly, a particular regime was designed for investment firms that were also registered as insurance intermediaries under the IMD. Those firms must comply with the requirements of Article 4.3 of the IMD in respect of those mediation activities and, additionally, are required in respect of their investment advisory activities to hold either an initial capital of at least €25,000, or PII insurance with a coverage of at least half the amount required under the IMD, or a combination of these two requirements. That is, the PII requirements imposed by the IMD must still be satisfied, however well capitalised the firm might be.

Recognising that the PII requirements of the MiFID would therefore differ from those of the IMD, some Member States argued during negotiations in Council that MiFID should modify the IMD so as to allow (re)insurance intermediaries to benefit from the option available to investment advisors to substitute, wholly or in part, PII requirements with capital. A modification to this effect was not adopted, but instead the co-legislators introduced the review clause.

The purpose of the review is to establish, on the basis of the evidence of their market impact in Member States, whether the combined requirements are proportionate to the objectives of adequate consumer protection and whether firms in the EEA as a whole, or in specific national markets, experience particular difficulties or expense in obtaining the required professional indemnity insurance which should be taken into account in reviewing the effectiveness of the regime.

---

2 Recital (8): "Member States should be able to establish rules stricter than those provided for in this Directive

3 COM (200) 625 final, Article 11.2

2. POLICY RATIONALE FOR PII REQUIREMENTS

PII requirements are a consumer protection measure, aimed at ensuring that client claims against an investment firm or intermediary can be met in cases where the income or capital of the firm or intermediary would not be sufficient to cover its liability to a client. But it is also valuable regulatory tool, enabling investment firms to carry out certain kinds of business with a relatively low base capital. This prevents the barrier to entry from being set too high, and the consequential exclusion of smaller firms from the market. This consideration is particularly relevant in the context of activities such as insurance mediation or investment advice, where there is a high incidence of small firms.

2.1. Consumer protection

PII clearly protects consumers by increasing the funds available to meet the claims arising from the receipt of negligent advice or some other form of professional misconduct. For example, MiFID regulates the service of investment advice for the first time as core service (it was an auxiliary service under the ISD). PII is a useful tool in ensuring that the risks associated with providing this service are properly managed.

2.2. Advantages to service providers and markets

PII also benefits the firms. Indeed, many firms hold PII when under no regulatory obligation to do so, or hold cover in excess of their regulatory obligations. It can finance large and unexpected liability claims and thereby protect the assets of its owners, and will normally cover both legal liability and the defence costs, the sum of which may be so substantial in some cases as to jeopardise the solvency of the firm.

PII may be particularly valuable for smaller firms which might find it difficult, or inappropriate to their business structure, to hold large amounts of capital. It can operate in conjunction with market forces by using the commercial insurance market to help maintain the solvency of firms that provide important retail services such as investment advice.

In addition, mandatory PII is a useful regulatory tool that can complement capital requirements and investor compensation schemes. The requirement to purchase PII might have a further positive regulatory effect in encouraging firms to improve their own risk assessment and risk control activities, as firms with a lower risk profile will tend to reduce the size of their premiums and increase the availability of cover.

Furthermore, it is in the general interests of the regulated community that firms should have PII cover, in order to limit the claims made on investor compensation schemes.[4] A firm that does not have adequate resources may not be able to meet justified claims that are made against it and ultimately could face insolvency. This could in turn lead to claims on the investor compensation scheme, which must be funded by the rest of the participant firms within the relevant contribution group. The greater the number of claims made on such schemes, the higher the industry levy to fund it. Since such levies are not risk sensitive, the

[4] When a loss occurs the PII policy provider pays a claim in accordance with the terms of the PII policy, and the firm has to pay an amount equal to the excess on its PII policy out of its own capital resources. When a firm's resources are exhausted, the firm is insolvent. Any justified consumer claims then fall on the relevant investor compensation scheme. Such a scheme will have limits, and any residual loss is incurred by the consumers.

costs of compensation may fall, disproportionately, on the long-lived, well-managed firms that provide most of the funding for the scheme. PII tends to reduce any such funding imbalance.

2.3. Arguments against PII requirements

The first and the most traditional argument levelled against PII is that it may create a problem of 'moral hazard'. This means that PII may alter the behaviour of those insured in ways that increase the probability or size of claims. The theory is that, having gained insurance protection, firms do not have the same financial incentive to avoid actions or omissions that might trigger claims.

Another argument against extensive PII requirements is that the insurance market lacks, or may lack, the capacity to provide PII cover to an increased number of firms. It has been alleged that the limits specified in the IMD were agreed at a time when there was more capacity in the market than there might be now or in the future. The situation may have been exacerbated by the requirements under MiFID for firms carrying on both activities, and there is some concern that the combination of requirements might stretch PII market to its limits, and some firms might be unable to hold the stipulated level of cover. A related concern is the cost of PII. By increasing the number of firms that are required to have PII, there is a risk that an increase in demand could push up the price of PII, drive some investment advice firms out of the market, and create a barrier to market entry for new firms.

More specifically, it has been argued that the IMD requires a high level of insurance, beyond that which most small firms would reasonably expect to hold. Moreover, those PII requirements are 'one size fits all', and not calibrated to the risk profile of the firm.

Commentators also urge appropriate recognition of the role of capital for insurance intermediaries. Capital can help finance unexpected losses or fill the gaps in a firm's PII cover, and, in particular, can help to finance any policy excess (that is, the first amount of a claim that has to be paid by the firm out of its own resources). Indeed, Articles 7 and 8 of the re-cast CAD recognise that capital, or a combination of PII and capital, can deliver the same consumer-protection objective as PII. The option to use financial resources to complement PII may give firms greater flexibility, help firms maintain adequate resources overall, and to obtain compliant PII cover in difficult market conditions.

3. Targeted Consultation with Member States and Competent Authorities

In March 2006 DG MARKT services addressed a questionnaire to the Member States and their respective competent authorities asking for information concerning the application of professional indemnity insurance under the IMD and the re-cast CAD. 19 responses to the questionnaire were received.[5] The responses have been compiled and published as part of the Draft Report on 14 August 2006. As we understand it, the incomplete number of responses is due to the fact that, at the time, the transposition of the IMD had only been completed recently

[5] Responses were received from Austria, Cyprus, the Czech Republic, Finland, France, Greece, Hungary, Ireland, Malta, Netherlands, Norway, Poland, Romania, Slovakia, Spain, Sweden, and the United Kingdom. Belgium, Denmark, Germany, Italy, Estonia, Latvia, Lithuania, Luxembourg and Portugal did not provide a response

in many Member States and that the transposition deadline for most of the provisions of the re-cast CAD had not yet expired.

For the same reasons, it is clear from the available responses that **Member States generally have little experience and available data on which to base an adequate assessment of the impact of the regime introduced by these directives on firms and protection it offers to consumers.** Furthermore, it is hard to predict what the impact will be on MiFID intermediaries that also carry on insurance intermediation business under the IMD. It seems that adequate data which would allow for a proper evaluation will not be available until early 2008.

The detailed Member States responses as well as the summary which is part of a draft report have been published and are available on the Commission web site[6].

4. PUBLIC CONSULTATION ON THE DRAFT REPORT

The Commission invited interested parties to comment on the Draft Report by 31 October 2006. The recommended format was for respondents to submit general remarks followed by answers to specific questions.

Comments were received from 7 organisations. One was pan- European and represented the joint response from insurance intermediary associations from 14 EU Member States. Of the others, 4 were based in the UK, one in Germany and one in Austria. The respondent organisations represented various sectors of the insurance industry (brokers, agents, insurers, underwriters), one represented independent financial advisers and one was a regulator. This section summarises the most important outcome of the public consultation.[7]

4.1. Results of the consultation

It is important to note that all respondents agreed that PII was an effective form of investor protection and most said that it could not be fully replaced by capital requirements. However, respondents were divided on the question as to whether the current regulatory PII regime is an appropriate investor protection measure. Some respondents argued for stricter PII requirements while others favoured a more flexible approach adapted to the size and risk profile of individual firms

Two respondents said that firms should be permitted to supplement or wholly replace PII protection with capital requirements to ensure that the lack of affordable PII would not lead to the failure of intermediaries.

One respondent representing insurance agents described the PII requirements as a significant and unnecessary burden which had prompted insurers to shift the cost of PII onto their agents.

Two respondents urged the Commission to undertake a further review of the situation once the Directives are in full operation in all Member States to enable a more complete assessment.

---

[6] http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm

[7] A more detailed summary of the responses to the specific questions is available at http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm

5. CONCLUSIONS

The analysis of the information provided by Member States as well as stakeholders in response to the two rounds of consultation suggests that, on the limited evidence that is currently available, the policy reasons that motivated the PII requirements imposed under community law remain valid, and there is insufficient evidence to indicate that those requirements are no longer appropriate.

However, it is also clear that it is too early to make a comprehensive assessment of how those requirements impact on the service providers and consumers. The regime under the IMD has only been in place in Member States for a short time, and States have no experience at all of the application of the new PII requirements for investment firms under the re-cast CAD. A proper evaluation of the continued appropriateness of those requirements cannot be made without more practical experience and data, and that will not be available until the requirements under the re-cast CAD have been implemented and applied in Member States for at least one year. Then, it may be appropriate to further investigate whether PII and capital requirements are adequate substitutes. Accordingly, the Commission will continue to monitor the situation if evidence of market failure emerges.