



**ASIC**

Australian Securities & Investments Commission

## CONSULTATION PAPER 125

# Compensation requirements for credit licensees: Further consultation

November 2009

### **About this paper**

This consultation paper follows Consultation Paper 111 *Compensation and financial resource arrangements for credit licensees* (CP 111), and seeks further feedback on specific aspects of ASIC's proposals on the compensation requirements that should apply to credit licensees.

We seek the views of potential credit licensees and representatives, consumers and insurers in relation to our proposals.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This paper was issued on 23 November 2009 and is based on the credit legislation and regulations as at 23 November 2009.

### Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

At the date of issue of this paper:

- the National Credit Act has not been given Royal Assent; and
- the regulations proposed to be made under that Act are in exposure draft form and therefore subject to change before being made final.

Once the regulations are made final, we will update our guidance if necessary.

# Contents

<b>The consultation process</b> .....	<b>4</b>
<b>A Background to the consultation</b> .....	<b>6</b>
Regulation of consumer credit .....	6
The compensation requirements .....	7
Consultation Paper 111 .....	8
Draft regulatory guide .....	10
Current consultation on the compensation requirements .....	10
<b>B Proposals for consultation</b> .....	<b>12</b>
Amount of cover .....	13
Run-off cover .....	16
Alternative approach for pure lenders .....	17
<b>C Regulatory and financial impact</b> .....	<b>18</b>
<b>List of proposals and questions</b> .....	<b>19</b>
<b>Attachment: Draft regulatory guide</b> .....	<b>21</b>
<b>Key terms</b> .....	<b>40</b>

## The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on the compensation requirements that should apply to credit licensees. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator report and/or a Regulation Impact Statement: see Section C, 'Regulatory and financial impact'.

### Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 18 December 2009 to:

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Strategic Policy  
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GPO Box 9827  
Melbourne VIC 3001  
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## What will happen next?

<b>Stage 1</b>	23 November 2009	ASIC consultation paper released
<b>Stage 2</b>	18 December 2009	Comments due on the consultation paper
	Early 2010	Finalisation of regulatory guide
<b>Stage 3</b>	March 2010	Regulatory guide released

## A Background to the consultation

### Key points

The National Consumer Credit Protection Act 2009 (National Credit Act) requires credit licensees (other than those that are also regulated by APRA) to have adequate arrangements in place for compensating consumers.

Generally, these arrangements are expected to consist of professional indemnity insurance (PI insurance) that is 'adequate', although ASIC may also approve alternative arrangements.

We have previously consulted on proposals about what we will expect of credit licensees under the new requirements, through Consultation Paper 111 *Compensation and financial resources arrangements for credit licensees* (CP 111). This current consultation seeks further feedback on three specific areas:

- the amount of cover that is 'adequate' for licensees other than 'pure lenders';
- the amount of cover that is 'adequate' for 'pure lenders' if they are not exempt from the requirement to hold PI insurance; and
- the availability of automatic 'run-off' cover

in light of recently released exposure draft regulations.

### Regulation of consumer credit

- 1 The Council of Australian Governments (COAG) agreed on 3 July 2008 that the Commonwealth would assume responsibility for the regulation of consumer credit. The Bill for the *National Consumer Credit Protection Act 2009* was passed by the Senate on 26 October 2009.
- 2 An exposure draft of the National Consumer Credit Protection Regulations 2010 was released for comment on 20 November 2009 (National Credit Regulations).
- 3 ASIC is responsible for regulating consumer credit in the new regime. A key component of the new credit regime is that businesses that provide credit services or that are engaged in other 'credit activities' must meet minimum compensation requirements.

## The compensation requirements

- 4 All credit licensees (other than those that are also APRA-regulated) must comply with the compensation requirements. Therefore, the compensation requirements apply to:
- (a) lenders that are not authorised deposit-taking institutions (ADIs); and
  - (b) non-lenders (e.g. finance brokers, mortgage brokers, credit advisers and loan advisers).

Note 1: A 'lender' is a person who provides credit to which the National Credit Code (Schedule 1 to the National Credit Act) applies or an assignee to whom s10 of the National Credit Act applies. A 'non-lender' is a credit licensee that either acts as an intermediary (as defined in s9 of the National Credit Act) or provides credit assistance (as defined in s8 of the National Credit Act).

- 5 Credit licensees must have in place adequate arrangements for compensating consumers for loss or damage suffered because of breaches of the relevant obligations in the National Credit Act by the licensee or its representatives. These arrangements must either satisfy the requirements prescribed in the regulations or be otherwise approved in writing by ASIC: see s48(2).

## Professional indemnity insurance

- 6 The National Credit Regulations require a credit licensee to hold, unless otherwise exempt, PI insurance cover that is 'adequate', having regard to:
- (a) the credit licensee's membership of an approved external dispute resolution scheme or schemes, taking into account the maximum liability that has, realistically, some potential to arise in connection with:
    - (i) any particular claim against the credit licensee; and
    - (ii) all claims in respect of which the credit licensee could be found to have liability; and
  - (b) relevant considerations in relation to the regulated credit business carried on by the licensee, including:
    - (i) the volume of the credit licensee's business;
    - (ii) the number and kind of clients;
    - (iii) the kind or kinds of credit activities; and
    - (iv) the number of representatives of the credit licensee (see reg 12).

## Alternative arrangements

- 7 When considering alternative arrangements, in addition to the adequacy measures in reg 12, ASIC must have regard to the credit activities carried on under the licence of the licensee and whether the arrangements will be

sufficient to cover consumers after the licensee ceases to engage in credit activities and for how long: see s48(3)(b).

### Exempt entities

- 8 Regulation 12(3) exempts general insurance companies, life insurance companies and ADIs regulated by APRA from the compensation requirements. It also includes companies that have an ASIC-approved guarantee from a related APRA-regulated entity.
- 9 Regulation 12(3)(c) also exempts credit providers whose sole business is lending (i.e. they only engage in credit activities as defined in items 1, 3, 4 and 5 of the table in s6(1) of the National Credit Act) from the requirement to hold PI insurance. We note that such lenders are not exempt from the general obligation to have in place adequate compensation arrangements; however, they are not necessarily required to satisfy this obligation through holding PI insurance as are most other licensees. We have referred to these credit providers as ‘pure lenders’ in this paper.

## Consultation Paper 111

- 10 We released Consultation Paper 111 *Compensation and financial resources arrangements for consumer credit* (CP 111) in July 2009. In CP 111, we consulted on how ASIC will administer the compensation requirements for credit licensees. We proposed to apply different compensation requirements to lenders and non-lenders, so that:
- (a) non-lenders would need to take out PI insurance, with the amount of cover required to be assessed on a sliding scale in accordance with the actual or expected revenue from retail credit activities (starting with a set minimum, and up to a capped maximum);
  - (b) lenders would need to self-assess the amount of PI insurance cover needed for their business, taking into account any assistance they might provide to consumers and the risks that may arise from such activities.

CP 111 also set out proposals relating to the financial requirements that will apply to credit licensees; however, the current consultation paper relates to compensation requirements only.

### Responses to consultation

- 11 We received 16 responses to CP 111 from a variety of sources including both large and small credit providers and other participants in the credit industry, relevant industry bodies, and legal bodies and law firms.



- 12 Generally, there was support for the approach proposed in CP 111, particularly for the approach we proposed to take in relation to non-lenders. Respondents had some particular comments to make in relation to our proposed approach to lenders, which are discussed in paragraphs 14–16.
- 13 Overall, we received comments from respondents about the following issues:
- (a) the overall approach to financial resources requirements for credit licensees;
  - (b) the application of compensation requirements to lenders;
  - (c) the minimum amount of PI insurance to be held by credit licensees that are not lenders;
  - (d) the appropriate test for distinguishing between lenders and non-lenders;
  - (e) PI insurance cover for representatives; and
  - (f) the requirement that credit licensees hold run-off cover.

### **Lenders versus non-lenders**

- 14 CP 111 proposed two tests for determining who is lender or a non-lender for the purposes of the compensation requirements:
- (a) a straightforward test (where any credit licensee that lends would be considered a lender, regardless of whether it undertook any non-lending credit activities); or
  - (b) a primary business test (where a licensee’s primary business would determine whether it would be considered a lender or non-lender for the purpose of these requirements).

While feedback generally supported a primary business test, respondents identified some concerns in using such a test and requested further clarification as to how this test might work in practice.

- 15 A number of responses to CP 111 argued that, rather than requiring lenders to self-assess how much PI insurance is appropriate for the risks inherent to the lending business, lenders should be formally exempted from the legislative requirement to hold PI insurance. These respondents argued that:
- (a) lenders would generally be better placed to meet compensation claims from their existing financial resources, as they must already hold sufficient funds in order to carry on their lending activities; and
  - (b) should a consumer suffer loss, the consumer could be compensated by other means than through payment of money, including through the variation of their contractual obligations under the loan.
- 16 From the feedback we have received, we agree that there is some argument for exempting lenders that do not engage in any non-lending credit-related

activities from the requirement to hold PI insurance cover. Regulation 12(3)(c) now also exempts ‘pure lenders’ from the requirement to hold PI insurance.

### **Amount of cover**

- 17 In CP 111, we also asked for specific feedback on the amount of PI insurance we should set for those licensees that are required to hold it (i.e. using the ‘primary business test’ proposed in CP 111, only licensees whose primary business is non-lending would be required to hold a minimum amount of PI insurance). We asked whether licensees should be required to hold a minimum of \$1 million in PI insurance cover (in line with existing requirements for finance brokers operating in WA), or \$2 million (in line with the minimum amount required for Australian Financial Services licensees in Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126)).
- 18 Opinion was divided about which level would be appropriate: some felt that \$2 million was a good minimum amount for non-lenders, where others argued that \$1 million would be sufficient. We think that this issue is complex, and warrants further consultation.

### **Run-off cover**

- 19 In CP 111, we proposed that an adequate PI insurance policy should include provision for ‘run-off’ cover, where it was readily available in the market. Respondents were generally supportive of this proposal.

## **Draft regulatory guide**

- 20 We have attached a draft new regulatory guide on compensation requirements for credit licensees to this consultation paper. We have based this on the compensation arrangements outlined in the National Credit Act and the National Credit Regulations, and the consultation we have undertaken so far. We welcome general feedback on this draft regulatory guide, in addition to responses to the specific proposals and questions set out in this consultation paper.

## **Current consultation on the compensation requirements**

- 21 We are undertaking this second consultation on the compensation requirements in order to seek further specific feedback on the following areas:

- (a) the amount of cover that should be held by credit licensees that are not exempt from the requirement to hold PI insurance (assuming that pure lenders are exempted by regulation);
- (b) the scope and availability of run-off cover for the credit industry; and
- (c) if pure lenders are not exempted from the requirement to hold PI insurance, whether ASIC should specify a minimum amount of cover for them (see Section B).

### **Lenders versus non-lenders**

- 22 We have modified our proposal from CP 111 based on the feedback we received and the current consultation paper sets out further proposals for credit licensees that are not exempt from the compensation requirements. We now propose that, unless they are exempted from the requirement to hold PI insurance by regulation, all credit licensees should hold a minimum amount of PI insurance: see proposal B1.
- 23 If, when final regulations are made, ‘pure lenders’ are not exempted from the requirement to hold PI insurance by regulation, we do not propose to specify what minimum amount of cover would be adequate. Instead we will allow them to self-assess the level of PI insurance that they will require: see proposal B3.

### **Amount of cover**

- 24 The approach we have proposed in this paper (i.e. that all credit licensees should hold a minimum amount of PI insurance unless exempted from the requirement by legislation), means that a broader range of licensees would need to hold a minimum amount of PI insurance than if we focused on the licensee’s primary business, as proposed in CP 111. The current consultation paper asks for specific feedback on the amount of PI insurance cover that is adequate in light of our revised approach: see proposal B1.

### **Run-off cover**

- 25 This consultation paper also sets out further proposals in relation to run-off cover, and asks for specific feedback about the commercial availability of such cover for the credit industry: see proposal B2.
- 26 Our experience in administering RG 126 suggests policies with run-off cover or an extended reporting period are not always readily available for Australian financial services (AFS) licensees. For this reason, we have recently amended RG 126 to state that we will not require AFS licensees to hold run-off cover for their financial services business. However, our understanding is that this is not the case within the credit industry and that run-off cover is generally available.

## B Proposals for consultation

### Key points

We propose that, unless they are specifically exempted from the requirement to hold PI insurance, all credit licensees should hold a PI insurance policy:

- that provides cover of an amount approximately equivalent to actual or expected revenue from credit activities, with a minimum of at least \$2 million per claim, and in the aggregate: see proposal B1; and
- that includes cover for claims that come to light after either the policy expires or the credit licensee ceases business: see proposal B2.

If pure lenders are not exempted from the requirement to hold PI insurance in the final form of the regulations, we will allow them to self-assess their PI insurance requirements: see proposal B3.

- 27 Unless exempt, a credit licensee is required to hold adequate PI insurance cover: reg 12(3)(c). One factor that is particularly relevant in assessing whether particular PI insurance policy is adequate for a credit licensee is the amount of cover provided (in terms of how appropriate this amount is to the nature, scale and complexity of the licensee's business and its other financial resources).
- 28 In CP 111, we set out proposals about the amount of cover a non-lender should hold and to allow lenders to assess this for themselves. We also suggested two alternative tests for distinguishing lenders from non-lenders for this purpose.
- 29 If the final form of the regulations exempts pure lenders from the requirement to hold PI insurance, then our policy on compensation requirements will not cover pure lenders, and we will not require the alternative tests proposed in CP 111 to distinguish lenders from non-lenders for the purposes of the compensation requirements. For this reason, we have proposed that all credit licensees should hold a minimum amount of PI insurance, unless specifically exempted from the requirement by legislation: see proposal B1.
- 30 Taking this approach would mean that a broader range of licensees would need to hold a minimum amount of PI insurance than if we focused on the licensee's primary business, as proposed in CP 111. For example, under the approach proposed in this paper, even if a licensee's primary business were lending, it would still need to hold PI insurance cover that is adequate in relation to any non-lending activities in which it also engages. For this reason, the current consultation paper revisits the issue of the amount of PI

insurance cover that is adequate in light of our revised approach: see proposal B1.

- 31 We have set out how we expect to regulate PI insurance for credit licensees in Section B of the draft regulatory guide attached to this consultation paper.
- 32 This section outlines our proposals for how the compensation requirements would apply to credit licensees that are not pure lenders (i.e. licensees who engage in a number of different credit-related activities, and that are not otherwise exempted from the requirement to hold PI insurance): see proposal B1.
- 33 We believe that another important aspect of an adequate PI insurance policy is that the policy continue to provide access for potential claims that come to light after either the policy expires or the credit licensee ceases business for a reasonable period. One means by which this may be achieved is through a PI insurance policy that provides for ‘run-off cover’. Our understanding is that PI insurance policies providing for run-off cover are generally available to the credit industry; we specifically seek feedback on this point: see proposal B2.
- 34 If pure lenders are not formally exempted by the final Regulations from the requirement to hold PI insurance, we propose to allow them to self-assess their PI insurance requirements: see proposal B3.

## Amount of cover

### Proposal

**B1** We propose that, unless they are exempted from the requirement to hold PI insurance by regulation, all credit licensees should hold PI insurance, and assess the amount they require on a sliding scale, as follows:

- (a) the policy should cover at least \$2 million per claim, and in the aggregate; and
- (b) cover should be approximately equivalent to actual or expected revenue from credit activities relating to consumers (up to a capped maximum of \$20 million cover).

To meet the compensation requirements, this cover would need to cover claims brought by consumers only. Non-lenders would need to obtain additional cover (under the same or a separate policy) for claims from lenders if they believe this is required.

#### *Your feedback*

B1Q1 Do you agree that it is appropriate for all credit licensees to be subject to the same compensation requirements unless they are exempted by regulation? Please give reasons.

B1Q2 An alternative approach to applying the requirements outlined in proposal B1 to all credit licensees that are not exempted from the requirement to hold PI insurance, is to apply the requirements to 'non-lenders' only, with 'lenders' and 'non-lenders' defined by reference to a 'primary business test' as follows:

- (a) a credit licensee that derived 75% or more of their revenue from lending business in the previous 12 months would be considered a lender; and
- (b) a credit licensee that derived less than 75% of their revenue from lending business in the previous 12 months would be considered a non-lender.

Do you think that it is appropriate to use such a test? How workable do you think this test will be in practice?

B1Q3 What is an appropriate minimum level of cover:

- (a) \$2 million (as currently applies to AFS licensees);
- (b) \$1 million (as currently applies to brokers licensed in WA); or
- (c) another level of cover? Please give reasons for your answer.

B1Q4 Should we set a cap on the maximum level of cover that licensees will be required to hold? If so, is \$20 million adequate? If not, please indicate the level you think would be more appropriate.

B1Q5 We think that to be adequate, PI insurance cover must include claims made against a licensee's credit representative and dealt with through that representative's external dispute resolution scheme. Do you think that this kind of cover is likely to be available to credit licensees?

## Rationale

- 35 As discussed in paragraphs 14–16, respondents to CP 111 argued that it was appropriate to distinguish between lenders and non-lenders in relation to the compensation requirements, as lenders are generally in a better financial position to meet financial claims, and consumers with claims against lenders may be compensated by a variation in the terms of the loan agreement in any case. Respondents also argued that, rather than applying specific compensation requirements to non-lenders, and allowing lenders to self-assess their PI insurance requirements, lenders should be exempted from the compensation requirements altogether, by regulation.
- 36 We agree that there is some basis for exempting lenders, which do not engage in any non-lending activities, from the requirement to hold PI insurance cover, and note that the current exposure draft regulations include an exemption for pure lenders: see reg 12(3)(c).

- 37           Should this exemption be included in the final version of the Regulations, we believe the simplest and most efficient approach to administering the compensation requirements will be to apply a single set of requirements to all credit licensees that are not exempted from the requirement to hold PI insurance. This is because we think that it will be difficult to develop and apply a test to distinguish between ‘lenders’ (of which the main business is lending, but that might also engage in a small amount of non-lending credit-related activities) and ‘non-lenders’, and this may create potential for businesses to be structured to avoid holding an appropriate minimum amount of PI insurance.
- 38           As noted in paragraph 14, CP 111 proposed two tests for determining who is lender or a non-lender for the purposes of the compensation requirements:
- (a) a straightforward test (where any credit licensee that lends would be considered a lender, regardless of whether it undertook any non-lending credit activities); or
  - (b) a primary business test (where a licensee’s primary business would determine whether it would be considered a lender or non-lender for the purpose of these requirements)—as noted in B1Q2, this could be applied using the percentage revenue derived from lending versus the revenue derived from non-lending.
- 39           In relation to the ‘straightforward’ test, we are concerned that its application could lead to arbitrary results, as applying it would mean that a licensee that only provides a small amount of credit in relation to non-lending activities would be deemed a ‘lender’. They would therefore not need to meet the specific compensation requirements, including the set minimum amount of cover. This would not be a result that would be in accordance with the risk profile of a business that predominantly carries on non-lending credit-related business. In relation to the ‘primary business’ test, we are aware that the revenue derived from lending is likely to be significantly higher than the revenue derived from non-lending. Therefore, even a small number of loans could push a credit licensee that mostly engages in non-lending activities into the category of a ‘lender’ for the compensation requirements.
- 40           Our experience in administering RG 126 suggests that a sliding scale approach to determining the amount of PI insurance cover to prescribe as adequate cover is appropriate to take account of the different business models that credit licensees might adopt. In particular, our experience suggests that smaller entities need minimum cover of at least \$1 million or possibly \$2 million in aggregate, with larger entities needing a larger amount. However, we welcome specific feedback on the appropriate level for both minimum and maximum cover required and also whether this cover should extend only to claims by consumers.

- 41 We also understand that many PI policies cover claims against non-lenders by both consumers and lenders. As claims by lenders may cause the cover to reach its annual limit very quickly, we believe they should be excluded from the prescribed minimum amount of cover. If non-lenders consider it is needed, they should obtain additional cover for claims from lenders.

## Run-off cover

### Proposal

- B2** We propose that, to be adequate, a PI insurance policy must cover claims that come to light after either the policy expires or the credit licensee ceases business, for a reasonable period (i.e. at least 12 months), as provided through:
- an extended reporting period; or
  - 'automatic' run-off cover (i.e. cover that applies where a licensee retires, sells the business or becomes insolvent).

#### *Your feedback*

- B2Q1** Do you agree with our proposal that an adequate policy must continue to provide access for potential claims for a reasonable period after the policy expires or the credit licensee ceases business? Please give reasons for your answer.
- B2Q2** Do you agree that PI insurance policies including automatic run-off cover are generally available to the credit industry? If you don't think they are available please tell us why?
- B2Q3** If run-off cover is available, is this 'automatic' run-off cover, which covers the circumstances in which a credit licensee retires, sells their business or becomes insolvent?
- B2Q4** Do you agree that PI insurance policies including run-off cover are generally available to licensees who hold both an AFS and credit licence for the part of their business relating to their credit activities?
- B2Q5** We think that an extended reporting period or run-off cover should apply for at least 12 months after the policy expires, or a credit licensee ceases business (see RG 000.26(d) of the attached draft regulatory guide). Do you agree that this is a reasonable period of time?

### Rationale

- 42 We think that an important aspect of an adequate PI insurance policy is that the policy should continue to provide access for potential claims that come to light after either the policy expires or the credit licensee ceases business for a reasonable period (e.g. automatic run-off cover or an extended reporting period).



## Alternative approach for pure lenders

### Proposal

- B3** If the Regulations do not exempt pure lenders from the requirement to hold PI insurance, we propose that they be able to self-assess their level of cover rather than be subject to the requirements set out in proposal B1.

Note: However, any other lender (i.e. one that also engages in some non-lending credit-related activities) would still need to meet the requirements set out in proposal B1.

#### *Your feedback*

- B3Q1** Do you agree it is appropriate for self assessment to apply only to pure lenders?

### Rationale

- 43 If pure lenders are ultimately not formally exempted from the requirement to hold PI insurance we will allow them to self-assess their PI insurance requirements as proposed in CP 111.
- 44 As discussed in paragraph 16, we agree with respondents to CP 111 that there is some argument for allowing pure lenders to assess their own compensation needs, including that:
- (a) lenders are likely to be better placed to meet compensation claims from their existing financial resources than non-lenders, as they must already hold sufficient funds in order to carry on their lending activities; and
  - (b) should a consumer suffer loss, the consumer could be compensated by other means than through payment of money, including through the variation of their contractual obligations under the loan.
- 45 We do not intend to extend this approach to lenders that also engage in some non-lending credit-related activities, due both to the different risk profile of such a business to that of a pure lender, and the difficulties of developing and applying a test to distinguish between ‘lenders’ and ‘non-lenders’ for the purposes of the compensation requirements outlined in paragraph 37–39.

## C Regulatory and financial impact

- 46 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) ensuring that consumers of credit products have access to adequate compensation mechanisms; and
  - (b) not causing credit licensees to incur unreasonable costs in settling their compensation arrangements.
- 47 Before settling on a final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:
- (a) considering all feasible options;
  - (b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;
  - (c) if our proposed option has more than low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis; and
  - (d) conducting the appropriate level of regulatory analysis, that is, complete a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).
- 48 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC Report and/or RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 49 To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide us with as much information as you can about:
- (a) the likely compliance costs;
  - (b) the likely effect on competition; and
  - (c) other impacts, costs and benefits,
- of our proposals or any alternative approaches: see ‘The consultation process’ p. 4.

## List of proposals and questions

Proposal	Your feedback
<p>B1 We propose that, unless they are exempted from the requirement to hold PI insurance by regulation, all credit licensees should hold PI insurance, and assess the amount they require on a sliding scale, as follows:</p> <p>(a) the policy should cover at least \$2 million per claim, and in the aggregate; and</p> <p>(b) cover should be approximately equivalent to actual or expected revenue from credit activities relating to consumers (up to a capped maximum of \$20 million cover).</p> <p>To meet the compensation requirements, this cover would need to cover claims brought by consumers only. Non-lenders would need to obtain additional cover (under the same or a separate policy) for claims from lenders if they believe this is required.</p>	<p>B1Q1 Do you agree that it is appropriate for all credit licensees to be subject to the same compensation requirements unless they are exempted by regulation? Please give reasons.</p> <p>B1Q2 An alternative approach to applying the requirements outlined in proposal B1 to all credit licensees that are not exempted from the requirement to hold PI insurance, is to apply the requirements to 'non-lenders' only, with 'lenders' and 'non-lenders' defined by reference to a 'primary business test' as follows:</p> <p>(a) a credit licensee that derived 75% or more of their revenue from lending business in the previous 12 months would be considered a lender; and</p> <p>(b) a credit licensee that derived less than 75% of their revenue from lending business in the previous 12 months would be considered a non-lender.</p> <p>Do you think that it is appropriate to use such a test? How workable do you think this test will be in practice?</p> <p>B1Q3 What is an appropriate minimum level of cover:</p> <p>(a) \$2 million (as currently applies to AFS licensees);</p> <p>(b) \$1 million (as currently applies to brokers licensed in WA); or</p> <p>(c) another level of cover? Please give reasons for your answer.</p> <p>B1Q4 Should we set a cap on the maximum level of cover that licensees will be required to hold? If so, is \$20 million adequate? If not, please indicate the level you think would be more appropriate.</p> <p>B1Q5 We think that to be adequate, PI insurance cover must include claims made against a licensee's credit representative and dealt with through that representative's external dispute resolution scheme. Do you think that this kind of cover is likely to be available to credit licensees?</p>

Proposal	Your feedback
<p>B2 We propose that, to be adequate, a PI insurance policy must cover claims that come to light after either the policy expires or the credit licensee ceases business, for a reasonable period (i.e. at least 12 months), as provided through:</p> <p>(a) an extended reporting period; or</p> <p>(b) 'automatic' run-off cover (i.e. cover that applies where a licensee retires, sells the business or becomes insolvent).</p>	<p>B2Q1 Do you agree with our proposal that an adequate policy must continue to provide access for potential claims for a reasonable period after the policy expires or the credit licensee ceases business? Please give reasons for your answer.</p> <p>B2Q2 Do you agree that PI insurance policies including automatic run-off cover are generally available to the credit industry? If you don't think they are available please tell us why?</p> <p>B2Q3 If run-off cover is available, is this 'automatic' run-off cover, which covers the circumstances in which a credit licensee retires, sells their business or becomes insolvent?</p> <p>B2Q4 Do you agree that PI insurance policies including run-off cover are generally available to licensees who hold both an AFS and credit licence for the part of their business relating to their credit activities?</p> <p>B2Q5 We think that an extended reporting period or run-off cover should apply for at least 12 months after the policy expires, or a credit licensee ceases business (see RG 000.26(d) of the attached draft regulatory guide). Do you agree that this is a reasonable period of time?</p>
<p>B3 If the Regulations do not exempt pure lenders from the requirement to hold PI insurance, we propose that they be able to self-assess their level of cover rather than be subject to the requirements set out in proposal B1.</p> <p>Note: However, any other lender (i.e. one that also engages in some non-lending credit-related activities) would still need to meet the requirements set out in proposal B1.</p>	<p>B3Q1 Do you agree it is appropriate for self assessment to apply only to pure lenders?</p>



**ASIC**

Australian Securities & Investments Commission

## REGULATORY GUIDE 000

# Compensation and insurance arrangements for credit licensees

November 2009

### About this guide

This guide is for credit licensees and insurers.

It sets out how ASIC will administer the compensation requirements under s47 of the *National Consumer Credit Protection Act 2009* (National Credit Act).

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This draft regulatory guide was issued on 23 November 2009 and is based on the credit legislation and regulations as at 23 November 2009.

### Disclaimer

This draft guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the credit legislation and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this draft guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

At the date of issue of this draft guide:

- the National Credit Act has not been given Royal Assent; and
- the regulations proposed to be made under that Act are in exposure draft form and therefore subject to change before being made final.

Once the regulations are made final, we will update our guidance if necessary.

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## Contents

<b>A Overview .....</b>	<b>24</b>
Legislative background .....	24
Our general approach.....	25
Meeting the compensation requirements .....	27
<b>B PI insurance .....</b>	<b>28</b>
Policy objective .....	28
What is 'adequate'? .....	28
Which entities can provide the cover?.....	32
Process for assessing adequacy and obtaining cover .....	32
<b>C Alternative arrangements and exemptions.....</b>	<b>36</b>
How to apply for approval.....	36
How we will assess applications.....	37
Licensees exempt under the National Credit Regulations .....	38
<b>Key terms .....</b>	<b>40</b>
<b>Related information.....</b>	<b>42</b>

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## A Overview

### Key points

If you are a credit licensee (and not also regulated by APRA) you must have adequate arrangements in place for compensating consumers: see RG 000.1–RG 000.5.

The primary way to comply with this obligation is to have professional indemnity insurance (PI insurance). ASIC may also approve alternative arrangements.

ASIC will administer the compensation requirements with the object of reducing the risk that credit licensees cannot meet claims for compensation, due to insufficient financial resources: see RG 000.6–RG 000.13.

Whether a PI insurance policy for credit licensees is adequate depends on the amount and scope of cover and the relevant terms and conditions of that policy.

### Legislative background

- RG 000.1 Under s48(1) of the *National Consumer Credit Protection Act 2009* (National Credit Act), a credit licensee must have in place adequate arrangements for compensating consumers for loss or damage suffered because of breaches of the relevant obligations in the National Credit Act by the licensee or its representatives.
- RG 000.2 These arrangements must either satisfy the requirements prescribed in the National Consumer Credit Protection Regulations 2010 (National Credit Regulations) or be otherwise approved in writing by ASIC as alternative arrangements. Regulation 12 requires a credit licensee to hold PI insurance cover that is adequate having regard to:
- (a) the licensee's membership of an external dispute resolution (EDR) scheme or schemes (including those schemes of which its credit representatives are members), taking account of the maximum liability that has, realistically, some potential to arise in connection with any particular claim against the licensee and all claims in respect of which the licensee could be found to be liable; and
  - (b) relevant considerations relating to the credit activities of the credit licensee, including:
    - (i) the volume of business;
    - (ii) the number and kind of clients;



- (iii) the kind or kinds of business; and
- (iv) the number of representatives.

RG 000.3 All credit licensees must comply with the compensation requirements unless exempt under the National Credit Regulations: see reg 12. Regulation 12 exempts from the compensation requirements:

- (a) a credit provider whose sole business is lending (i.e. it only engages in credit activities as defined in items 1, 3, 4 and 5 of the table in s6(1) of the National Credit Act);
- (b) an ADI, general insurance company or life insurance company regulated by the Australian Prudential Regulation Authority (APRA); and
- (c) a company for which a related, APRA-regulated entity has provided a guarantee approved by ASIC.

RG 000.4 This means that the credit licensees that have to comply with the requirement to hold PI insurance are:

- (a) lenders that undertake some non-lending credit activities; and
- (b) credit licensees that undertake non-lending credit activities (such as finance brokers, mortgage brokers, credit advisers and loan advisers). We refer to these credit licensees as ‘non-lenders’.

Note: A ‘lender’ is a person who provides credit to which the National Credit Code (Schedule 1 to the National Credit Act) applies or the assignee of a credit provider (see s10). A ‘non-lender’ is a person who either acts as an intermediary (as defined in s9) or provides credit assistance (as defined in s8).

RG 000.5 When considering alternative arrangements, in addition to the adequacy measures in reg 12, ASIC must have regard to the credit activities carried on under the credit licence and whether the arrangements will be sufficient to cover consumers after the licensee ceases to engage in credit activities, and for how long: see s48(3)(b). This is discussed further in Section C.

Note: In this guide, the requirements set out in s48 of the National Credit Act and reg 12 of the National Credit Regulations are referred to as the ‘compensation requirements’.

## Our general approach

### Our objective

RG 000.6 Our objective in administering the compensation requirements is to reduce the risk that losses sustained by consumers cannot be compensated by a credit licensee because of a lack of available financial resources.

- RG 000.7 The proposed compensation requirements are not, however, meant to be a mechanism for providing compensation directly to consumers and may not cover all possible consumer losses.

### **Our approach**

- RG 000.8 We think that three main factors are particularly relevant to determining whether a PI insurance policy is adequate for the purposes of the compensation requirements:
- (a) the amount of the cover;
  - (b) the scope of the cover; and
  - (c) whether any of the terms and conditions of the policy would undermine its overall effect (e.g. by excluding cover for key aspects of the credit licensee's business).

Our requirements in relation to each of these elements are discussed further in Section B. In addition, Table 2 (in Section B) sets out questions we think will assist licensees in determining whether a PI insurance policy is adequate.

- RG 000.9 The standards we have set in relation to what constitutes adequate PI insurance cover will also set the benchmark for ASIC approval of any alternative compensation arrangements proposed by credit licensees.

### **What this means for credit licensees**

- RG 000.10 Credit licensees will need to determine whether they are legally required to hold PI insurance, or whether they can rely on an exemption from this requirement: see RG 000.3.
- RG 000.11 If a licensee is subject to the requirement to hold PI insurance, then it must hold a policy that:
- (a) provides at least \$2 million in cover per claim and in the aggregate; and
  - (b) meets the other requirements we have set in relation to the scope of the cover (see Section B).
- RG 000.12 If a licensee wishes to use a compensation mechanism other than PI insurance in order to meet its obligations under the National Credit Act, it must apply to ASIC for approval to use this arrangement.

### **What this means for consumers**

- RG 000.13 Our approach in administering the compensation requirements is designed to reduce the risk that credit licensees will have insufficient financial resources to compensate losses sustained by consumers.

## Meeting the compensation requirements

RG 000.14 Credit licensees must meet the compensation requirements in order to undertake credit activities. For further information on how we will assess compensation requirements during the credit licence application process, see Regulatory Guide 204 *Applying for and varying a credit licence* (RG 204).

Note: RG 204 will be released in mid-December 2009.

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## B PI insurance

### Key points

ASIC will administer the compensation requirements to reduce the risk that losses sustained by consumers cannot be compensated by credit licensees: see RG 000.15–RG 000.16.

Whether a PI insurance policy for a credit licensee (other than one that is also APRA-regulated) is adequate depends on three factors:

- the amount of the cover (see RG 000.19–RG 000.23);
- the scope of the cover (see RG 000.24–RG 000.26); and
- whether the terms and conditions of the cover undermine the overall effect (e.g. by excluding cover for key aspects of the credit licensee’s business) (see RG 000.27–RG 000.31).

Based on these factors, licensees should assess what is adequate PI insurance cover to meet their obligations under s48(2) and obtain such cover: see RG 000.33–RG 000.40.

### Policy objective

- RG 000.15 Our objective in administering the compensation requirements is to reduce the risk that losses sustained by consumers cannot be compensated by a credit licensee because of a lack of available financial resources.
- RG 000.16 The proposed compensation requirements are designed to reduce this risk of uncompensated consumer losses. They are not, however, meant to be a mechanism for providing compensation directly to consumers and may not cover all possible consumer losses.

### What is ‘adequate’?

- RG 000.17 The National Credit Regulations provide that, unless otherwise exempt, a credit licensee must hold PI insurance cover that is adequate, having regard to:
- (a) the credit licensee’s membership of an approved external dispute resolution scheme or schemes, taking into account the maximum liability that has, realistically, some potential to arise in connection with:
    - (i) any particular claim against the licensee; and

- (ii) all claims in respect of which the licensee could be found to have liability; and
- (b) relevant considerations relating to the regulated credit business carried on by the credit licensee, including:
  - (i) the volume of the licensee's business;
  - (ii) the number and kind of clients;
  - (iii) the kind or kinds of credit activities; and
  - (iv) the number of representatives of the licensee.

It should be noted that this is not an exhaustive list of the factors that credit licensees need to take into account in assessing what PI insurance cover is adequate in their circumstances.

Note: See reg 12.

- RG 000.18 We think the following factors are particularly relevant in determining whether a PI insurance policy for a credit licensee is adequate:
- (a) the amount of the cover;
  - (b) the scope of the cover; and
  - (c) whether the terms and conditions of the cover undermine the overall effect (e.g. by excluding cover for key aspects of the credit licensee's business).

### **Amount of cover**

- RG 000.19 If a PI insurance policy is going to be an effective mechanism for compensating consumer losses, the amount of cover provided must be sufficient. In this context, this means both:
- (a) the per-claim limit of indemnity—that is, the maximum insurance cover for each individual claim; and
  - (b) the aggregate limit of indemnity—that is, the maximum insurance cover for all claims.
- RG 000.20 What is an adequate amount of cover will differ between credit licensees. More specifically, the following considerations are relevant:
- (a) the extent of the credit activities undertaken by a credit licensee, including the scale of activities undertaken by credit representatives;
  - (b) the nature of its business; and
  - (c) the likelihood of claims against that credit licensee.

Note: See reg 12.

- RG 000.21 We have set minimum requirements for the amount of PI insurance cover that credit licensees should hold. That is, credit licensees that are required to

hold PI insurance should assess the amount of PI insurance that they require on a sliding scale, as follows:

- (a) the policy should cover at least \$2 million per claim, and in the aggregate; and
- (b) cover should be approximately equivalent to actual or expected revenue from credit activities relating to consumers (up to a capped maximum of \$20 million).

Note 1: Revenue has the same meaning in this context as in AASB 118 *Revenue*.

Note 2: For the purposes of this minimum requirement, a credit licensee's revenue should be calculated including the revenue that any credit representatives receive from engaging in credit activities for consumers.

Note 3: Revenue may be calculated based on the financial year ended prior to taking out the insurance policy and reassessed on each policy renewal. For new licensees, or if a licensee believes revenue is likely to substantially change, the licensee should make an estimate of expected revenue.

RG 000.22 We understand that many PI policies cover claims against non-lenders by both consumers and lenders. As claims by lenders may cause the cover to reach its annual limit very quickly, we believe they should be excluded from the prescribed minimum amount of cover. If non-lenders consider it is needed, they should obtain additional cover for claims by lenders.

RG 000.23 Some credit licensees will require larger amounts of cover than others for their PI insurance policies to be adequate. Credit licensees must retain records of how they determined what amounts were adequate for them.

### Scope of cover

RG 000.24 Section 48(1) requires that the compensation arrangements cover loss or damage suffered because of a contravention of an obligation under the National Credit Act by the credit licensee or its representatives.

RG 000.25 Credit licensees are subject to broad obligations under the National Credit Act, including a duty do all things necessary to ensure that the credit activities authorised by their licences are engaged in efficiently, honestly and fairly. Credit licensees are also subject to a range of specific obligations. Losses caused by negligent, fraudulent or dishonest conduct that amounts to a breach of the National Credit Act should be covered.

RG 000.26 ASIC's minimum expectations as to the key features of an adequate PI insurance policy are that the policy must:

- (a) cover loss or damage suffered by consumers because of breaches of obligations under the National Credit Act or licence obligations;

Note: The policy need not explicitly refer to 'breaches of obligations under the National Credit Act or licence obligations' or 'compensation awards made by EDR scheme(s)'. The policy must, however, have the effect of providing cover for breaches of these obligations and for meeting those awards.

- (b) cover breaches by both the credit licensee and its representatives;

Note 1: Credit licensees need to take into account all of their representatives (not just credit representatives) when considering the type and extent of cover that will be adequate. This is because a consumer will generally have the same remedies against a credit licensee as against its representatives.

Note 2: The credit licensee's policy does not need to indemnify the licensee for acts of its representatives if such acts are adequately covered by the representatives' own PI insurance cover and the licensee has a contractual right to be indemnified by its representatives.

- (c) be available to cover compensation awards made by the EDR scheme(s) to which the credit licensee and its representatives belong; and
- (d) continue to provide access for potential claims that come to light for a reasonable period (i.e. at least 12 months) after either the policy expires or the credit licensee ceases business (e.g. automatic run-off cover or an extended reporting period).

Note: It is our understanding that different participants in the insurance market use different terminology to describe run-off cover. We expect a credit licensee to have automatic run-off cover that applies where the licensee retires, sells the business or becomes insolvent. Credit licensees that have obtained run-off cover in the past should review their existing policies carefully to determine whether that run-off cover is automatic in nature.

### **Terms and conditions that undermine the effect of the policy**

- RG 000.27 Even if a PI insurance policy generally meets our requirements in relation to the amount of cover and scope, if any individual terms and conditions would undermine the overall effect of the policy it will not be adequate. Particular examples of such terms and conditions include those providing for exclusions, excesses and deductibles.

#### **Exclusions**

- RG 000.28 Exclusions in a PI insurance policy that impact on the credit licensee's ability to compensate consumer losses will ordinarily make that policy inadequate, especially exclusions that relate directly to the minimum scope of cover outlined above. In general, a policy containing exclusions relating to breaches of the National Credit Act and the associated regulations would not be adequate.

- RG 000.29 More specifically, we consider exclusions dealing with the following to be significant:

- (a) EDR scheme awards and awards made by the Federal Court under the proposed small claims (i.e. up to \$40,000) jurisdiction;

Note: A policy will not be inadequate merely because it contains a lower sub-limit on the amount that can be claimed as a result of an EDR scheme award.

- (b) loss caused by the conduct of representatives;

- (c) fraud and dishonesty by agents and representatives; and
- (d) claims for misrepresentations about services.

### **Excesses and deductibles**

- RG 000.30 Excesses and deductibles are common features of PI insurance policies currently in the market. However, a high excess or deductible might have the effect of the credit licensee having to draw heavily on its financial resources before being able to draw on the policy to meet a consumer's claim for compensation.
- RG 000.31 Credit licensees must assess what financial resources are required (to cover the excess and gaps in cover due to various exclusions) and ensure that they have such funds available. Licensees should be able to demonstrate to us that they have such financial resources available, and should retain records of those assessments. These records should indicate how the financial resources were calculated (e.g. using capital, cash flow, overdraft or support from a parent company).

Note: See Regulatory Guide 207 *Credit licensing: Financial requirements* (RG 207) for guidance on measuring financial resources. RG 207 will be released in mid-December 2009.

## **Which entities can provide the cover?**

- RG 000.32 Our experience in administering other compensation arrangements is that it is crucial that licensees only hold PI insurance cover from financially sound and well-regulated insurers. As such, we believe that only an insurer that is regulated by APRA under the *Insurance Act 1973*, or is exempted from regulation under that Act, is able to provide adequate cover. This does not prevent licensees from seeking ASIC approval of alternative arrangements with bodies other than these. Such arrangements are discussed further in Section C.

## **Process for assessing adequacy and obtaining cover**

- RG 000.33 Whether a PI insurance policy is adequate for a particular credit licensee depends on all of the relevant facts and circumstances, including the nature, scale and complexity of the credit licensee's business and its other financial resources. It is therefore left to each credit licensee to determine what level of PI insurance is adequate to meet its obligations under s48(2). Some credit licensees might find it helpful to engage external consultants, actuaries, brokers or advisers to undertake risk assessments of their businesses and provide advice on the amount and type of cover that they should obtain.



RG 000.34 ASIC's role is not to assess the adequacy of every PI insurance policy covering credit licensees. Therefore, ASIC will not formally 'approve' a credit licensee's PI insurance arrangements, whether or not the credit licensee already has PI insurance cover in place upon the commencement of the National Credit Act.

### Initial assessment

RG 000.35 As noted in RG 000.17, credit licensees should consider the list of factors in reg 12 regarding what constitutes adequate PI insurance cover. However, this should not be regarded as an exhaustive list of all of the relevant factors to consider. For example, the terms of the insurance policy itself will also be relevant to whether the policy is adequate.

RG 000.36 We suggest that licensees use the assessment process outlined in Table 1 to determine what will be adequate PI insurance for them.

**Table 1: Initial assessment process**

Step 1	Assess the business, including claims history, level of business, and risk management procedures (including proposed changes to the business).
Step 2	Assess potential liability. We suggest that a credit licensee can determine 'the maximum liability that has, realistically, some potential to arise', as required by reg 12, by making a reasonable estimate of the following factors: <ul style="list-style-type: none"> <li>• the maximum exposure to a single consumer (worst-case scenario);</li> <li>• the number of claims that could arise from a single event (potential for multiple claims); and</li> <li>• the number of claims that might be expected during the policy period.</li> </ul>
Step 3	Ask insurers or insurance brokers for a list of key policy features, exclusions and available extensions (based on full disclosure of the information the licensee has assembled under Steps 1 and 2).
Step 4	Consider whether the amount and scope of cover is adequate in light of the factors identified in Section B.
Step 5	Review the policy by asking a series of questions (outlined in Table 2) as to the adequacy of the cover.

RG 000.37 We suggest that licensees review the policy features by asking the key questions in Table 2. This will help determine whether a particular policy is adequate.

**Table 2: Key questions for credit licensees**

<b>Policy features</b>	<b>Questions to ask</b>
<b>Scope of cover and extensions</b>	<p>Does the policy cover:</p> <ul style="list-style-type: none"> <li>• losses from breaches of the National Credit Act by the credit licensee and its representatives;</li> <li>• negligence and other common law claims generally;</li> <li>• fraud and dishonest conduct by agents and representatives;</li> <li>• EDR scheme awards relating both to the credit licensee and all of its representatives; and</li> <li>• agreements reached through the EDR scheme conciliation process?</li> </ul>
<b>Amount of cover</b>	<p>Does the policy have an adequate level of indemnity to cover a reasonable estimate of consumer losses?</p> <p>Is the level of indemnity adequate to cover claims brought both inside and outside EDR schemes?</p> <p>Does the level of indemnity cover claims for losses relating to activities for which a credit licence is not required? This is important as these claims can reduce the amount of cover available for claims that are made by consumers, meaning the licensee might need to increase the level of cover to take account of this.</p> <p>Are defence costs covered separately from the amount of indemnity cover?</p> <p>Does the policy provide for automatic reinstatement? This means that if the limit of the policy is exhausted before the end of the policy period, the credit licensee can pay a new premium so that the limit of indemnity is reinstated for the balance of the period, to cover any new claims that might arise before the policy is renewed.</p> <p>Does the business carry a higher risk of claims or is it exposed to a higher volume of claims and therefore require a larger amount of PI insurance cover?</p> <p>Have weaknesses been identified in your compliance systems, such as a high number of claims or high-risk products/practices, which might mean a higher level of cover is required?</p>
<b>Excesses and deductibles</b>	<p>If the policy includes an excess, is the excess at a level that the business can confidently sustain as an uninsured loss, taking into account the credit licensee's financial resources?</p>
<b>Exclusions</b>	<p>What are the exclusions from cover? Are the exclusions significant? Does the credit licensee have sufficient financial resources to cover these exclusions?</p>
<b>Approved product list</b>	<p>Is cover limited to services provided in relation to an agreed list of products?</p>
<b>Who is covered</b>	<p>Does the policy cover the credit licensee and all of its representatives? This coverage can be under the primary policy or under a separate policy under which the credit licensee has a right of indemnity.</p> <p>Are there many representatives and are they geographically dispersed? If so, the limit of indemnity might need to be appropriately higher to manage this risk.</p>
<b>Retroactive cover</b>	<p>If the credit licensee had a previous PI insurance policy prior to being licensed, does the new policy provide retroactive cover from the date of expiration of the previous policy?</p>
<b>Run-off cover</b>	<p>Does the policy provide automatic run-off cover or an extended reporting period? If so, for how long?</p> <p>Note: Automatic run-off cover is cover that has effect regardless of the reason for a credit licensee ceasing credit activities. It must, therefore, cover the situation where a credit licensee retires or otherwise sells its business and where the credit licensee becomes insolvent.</p>

### **Ongoing assessment**

- RG 000.38 We expect that credit licensees will review their PI insurance or other compensation arrangements at least annually to ensure they continue to be adequate (e.g. when existing policies are due for renewal). Licensees should also review the adequacy of compensation arrangements in light of any major changes to their businesses (e.g. starting to provide new services or products or engaging more representatives).

### **Compliance systems**

- RG 000.39 We expect credit licensees will ensure that senior people are accountable for ensuring that their PI insurance policies are renewed when required, that premiums are paid on time and that their insurance or other compensation arrangements continue to be adequate. Licensees will need to make provision in internal dispute resolution systems for ensuring that claims are promptly notified to insurers.

### **Licence conditions**

- RG 000.40 Credit licensees that are not otherwise exempted from the requirement to hold PI insurance under the National Credit Regulations will be subject to a specific licence condition that they obtain PI insurance that is adequate in terms of its amount, scope, and other terms and conditions.

## C Alternative arrangements and exemptions

### Key points

A credit licensee wishing to apply for ASIC approval of alternative compensation arrangements under s48(2) needs to lodge an application for approval: see RG 000.41–RG 000.46.

Applications for approval of alternative arrangements will be assessed on a case-by-case basis: see RG 000.47–RG 000.51.

A subsidiary of an APRA-regulated entity that is a credit licensee may be exempt from the requirement to hold PI insurance, where it has an approved guarantee from that APRA-regulated entity: see RG 000.53–RG 000.55.

### How to apply for approval

- RG 000.41 Credit licence applicants will be asked on the licence application form whether they are going to seek ASIC approval for compensation arrangements other than PI insurance. Licensees should apply for approval of alternative arrangements as part of the licence application process.
- RG 000.42 Some examples of hypothetical alternative arrangements are provided at Table 3. These are examples only and we will assess applications for alternative arrangements on a case-by-case basis. By including these examples in the table, we make no statement as to whether arrangements of this kind would always constitute ‘adequate’ compensation arrangements or would be approved by ASIC in any particular circumstance or for any given credit licensee.
- RG 000.43 We expect that an application for ASIC approval of alternative compensation arrangements will address the following issues:
- (a) whether more than one credit licensee will be covered by the arrangements and, if so, who they are. This will apply where the arrangements cover a group of related credit licensees or an industry sector or other sub-group of licensees;
  - (b) how the arrangements provide protection comparable to PI insurance (see Section B);
  - (c) any benefits, risks or costs to consumers arising from the credit licensees using these arrangements rather than PI insurance; and
  - (d) any circumstances particular to the credit licensee(s) or the industry sector that make these arrangements more appropriate than PI insurance.

- RG 000.44 We will assess each application on its merits. We will give priority to group applications, for example, where they apply to an industry sector or sub-sector.
- RG 000.45 Where a credit licensee with high levels of financial resources wishes to self-insure (i.e. cover the cost of claims using its own available financial resources) rather than hold PI insurance, we will assess these arrangements using the same process as for other arrangements.

**Table 3: Examples of hypothetical alternative arrangements (subject to case-by-case approval)**

<b>Industry member fund</b>	<p>Alternative arrangements proposed by an industry body may be approved by ASIC. For example, an industry body's members might wish to set up a compensation fund supported by compulsory levies of members.</p> <p>This could be in addition to PI insurance (i.e. to compensate consumers where a member's insurance is inadequate or it ceases trading or becomes insolvent) or instead of PI insurance. Approval of a fund would depend on the amount of compensation that would be available for consumers and the circumstances in which the fund would compensate consumers.</p> <p>We encourage industry bodies to consider whether alternative arrangements are appropriate for their members and we are keen to discuss any such arrangements further with them.</p>
<b>Self-insurance</b>	<p>Some very highly capitalised credit licensees might take a self-insurance approach (i.e. to completely replace PI insurance). This might be appropriate for credit licensees that are so substantial that failure to pay claims is very unlikely. This is akin to the exemption for some APRA-regulated entities.</p> <p>We believe that only credit licensees that are very highly capitalised will find this an adequate alternative to PI insurance cover.</p>
<b>Discretionary mutual fund</b>	<p>Discretionary mutual funds (DMFs) are entities that offer 'discretionary cover'—that is, an insurance-like product that may involve an obligation on the DMF to consider meeting a claim made on it, but gives the DMF a discretion as to whether it will pay the claim. A DMF may be a trust, mutual, company limited by guarantee or other structure.</p>

- RG 000.46 Our policy on relief applications is set out in Regulatory Guide 51 *Applications for relief* (RG 51). In addition to this policy, we will also consider the intention behind the introduction of s48, which is that all credit licensees have arrangements to minimise the risk that consumer losses cannot be compensated. On this basis, it is unlikely that we would grant relief from the requirements in s48 and reg 12.

## How we will assess applications

- RG 000.47 Under reg 12, when deciding whether to approve alternative compensation arrangements, we are required to have regard to:
- (a) the nature of the credit activities undertaken; and

- (b) whether the arrangements provide cover after the credit licensee ceases the business and, if so, for how long.

RG 000.48 The regulation also explicitly requires us to take into account the factors we use to assess adequacy of PI insurance, before approving alternative arrangements. This means that alternative arrangements must also be adequate having regard to:

- (a) the credit licensee's membership of an EDR scheme or schemes (including the schemes of which the licensee's credit representatives are members), taking into account the maximum liability that has, realistically, some potential to arise;
- (b) the volume of business;
- (c) the number and kind of clients;
- (d) the kind or kinds of business; and
- (e) the number of representatives.

RG 000.49 When an individual credit licensee asks us to approve alternative arrangements, it should follow the steps outlined in Table 2 (in Section B) and share the outcome of this assessment with us. This will help us evaluate whether the alternative arrangements are adequate. If the credit licensee is unable to demonstrate confidently that its proposed alternative arrangements can cover the estimated exposure (as confirmed by an external expert, such as an auditor or actuary), we are unlikely to approve the arrangements.

RG 000.50 When a credit licensee seeks approval of alternative arrangements, we will consider whether the proposals will achieve the legislative objective of ensuring compensation for consumer losses.

RG 000.51 We will assess applications for alternative arrangements by comparing them to PI insurance arrangements, to ensure that credit licensees and consumers have comparable protection where alternative arrangements are used in lieu of PI insurance.

## Licensees exempt under the National Credit Regulations

RG 000.52 The National Credit Regulations provide that certain credit licensees are exempt from the compensation requirements. This applies to:

- (a) a credit licensee that only provides credit;
- (b) an ADI, general insurance company or life insurance company regulated by APRA that also undertakes credit activities; and
- (c) a subsidiary of an APRA-regulated institution that has a guarantee, approved by ASIC, from that institution.

### **Guarantee provided by APRA-regulated institution**

- RG 000.53 A credit licensee that is related to any APRA-regulated institution (i.e. an ADI, general insurance company or life insurance company) is also exempt where it has a guarantee provided by the APRA-regulated institution and approved by ASIC.
- RG 000.54 ASIC will approve guarantees only where they provide no less protection than adequate PI insurance cover: see reg 12.
- RG 000.55 In considering whether to approve a guarantee of this nature, we will consider the same factors outlined in Section B in relation to the adequacy of PI insurance. APRA-regulated entities are permitted to give guarantees that are limited in time and amount, and we have no in-principle objection to such limits in guarantees put to us for approval (assuming, of course, that the limits are appropriate in the circumstances).

## Key terms

Term	Meaning in this document
ADI	An authorised deposit-taking institution as defined under the <i>Banking Act 1959</i>
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
automatic reinstatement	If the limit of the policy is exhausted before the end of the policy period, upon payment of a new premium the limit of indemnity is reinstated for the balance of the period, to cover any new claims that may arise. The number of automatic reinstatements refers to the number of times the limit of indemnity may be reinstated
compensation requirements	The requirements of s48 of the National Credit Act and reg 12 of the National Credit Regulations
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
credit legislation	Has the meaning given in s5 of the National Credit Act
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	A person who holds an Australian credit licence under s35 of the National Credit Act
credit provider	Has the meaning given in s5 of the National Credit Act
credit representative	Authorised representative of a credit licensee under the National Credit Act
EDR scheme	An external dispute resolution scheme approved by ASIC under RG 139
lender	A credit provider Note: The term 'lender' should be distinguished from the term 'pure lender', which refers to those lenders that do not engage in any non-lending credit activities, and that are exempted from the requirement to hold PI insurance under reg 12(3)(c) of the National Credit Regulations.



Term	Meaning in this document
National Credit Act	Either: <ul style="list-style-type: none"> <li>• <i>National Consumer Credit Protection Act 2009</i>; or</li> <li>• before Royal Assent is given to that Act—the National Consumer Credit Protection Bill 2009</li> </ul>
National Credit Code	National Credit Code at Schedule 1 of the National Credit Act
National Credit Regulations	Either: <ul style="list-style-type: none"> <li>• National Consumer Credit Protection Regulations 2010; or</li> <li>• before these regulations are made final—Exposure Draft National Consumer Credit Protection Regulations released by Treasury in November 2009</li> </ul>
non-lender	All credit licensees that are not lenders. This category includes persons who provide credit assistance under s8 of the National Credit Act and persons who act as intermediaries under s9 of the National Credit Act
PI insurance	Professional indemnity insurance
pure lender	A credit provider whose sole business is lending (i.e. it only engages in credit activities as defined in items 1, 3, 4 and 5 of the table in s6(1) of the National Credit Act)
reg 8 (for example)	A regulation of the National Credit Regulations (in this example numbered 8)
RG 148 (for example)	An ASIC regulatory guide (in this example numbered 148)
run-off cover	Cover for claims made after the insurance policy has ended that have arisen from the acts or omissions of the insured during the period of insurance cover
s35 (for example)	A section of the National Credit Act (in this example numbered 35), unless otherwise specified

## Related information

### Headnotes

Australian credit licence, compensation arrangements, credit activities, consumers, professional indemnity insurance, adequate professional indemnity insurance, risk management, external dispute resolution scheme, representatives, authorised insurer, direct offshore foreign insurer, alternative compensation arrangements

### Regulatory guides

RG 51 *Applications for relief*

RG 204 *Applying for and varying a credit licence*

RG 207 *Credit licensing: Financial requirements*

### Legislation

*Banking Act 1959*

*Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007*

*Insurance Act 1973*

National Credit Act, Ch 2 Pt 2-2 Div 5, s6, 8, 9, 10, 35, 47, 48; National Credit Code, s204; National Credit Regulations, reg 12

### Consultation papers and reports

CP 111 *Compensation and financial resources arrangements for credit licensees* (July 2009)