REPORT 193

Response to submissions on CP 125 Compensation requirements for credit licensees: Further consultation

March 2010

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 125 *Compensation requirements for credit licensees: Further consultation* (CP 125) and details our responses to those issues.

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.

Disclaimer

This report 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.

This report does not contain ASIC policy. Please see Regulatory Guide 210 *Compensation and insurance arrangements for credit licensees* (RG 210).

Contents

A Overview/consultation process

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 National Credit Act by the licensee or its representatives.

2 These arrangements must either satisfy the requirements prescribed in the National Consumer Credit Protection Regulations 2010 (National Credit Regulations) or be otherwise approved by us in writing as alternative arrangements. Regulation 12 requires a credit licensee to hold professional indemnity (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; and

(ii) the number and kind of clients.

3 In Consultation Paper 125 *Compensation requirements for credit licensees: Further consultation* (CP 125), we sought feedback on proposals in relation to the amount and scope of PI insurance that is 'adequate' for the purposes of meeting the requirements of the credit legislation. These proposals were developed as a result of feedback to our earlier consultation paper on compensation requirements for credit licensees, Consultation Paper 111 *Compensation and financial resources arrangements for credit licensees* (CP 111).

4 In CP 125, we proposed that:

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

(i) the policy should cover at least $2 million per claim, and in the aggregate; and

(ii) 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);

(b) 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:

(i) an extended reporting period; or

(ii) 'automatic' run-off cover (i.e. cover that applies where a licensee retires, sells the business or becomes insolvent); and

(c) if the National Credit Regulations did not exempt pure lenders from the requirement to hold PI insurance, that they be able to self-assess their level of cover.

CP 125 also included an attached draft version of a new regulatory guide setting out compensation requirements for credit licensees.

5 This report highlights the key issues that arose out of the submissions received to CP 125 and our responses to those issues. Feedback received to CP 125 was used to finalise our policy, which is published in Regulatory Guide 210 *Compensation and insurance arrangements for credit licensees* (RG 210). Where relevant, this report explains where we have modified the policy proposed in CP 125, in producing our final guidance.

6 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 125. We have limited this report to the key issues.

7 For a list of the non-confidential respondents to CP 125, see Appendix 1. Copies of the submissions are on our website at www.asic.gov.au/cp, under CP 125.

Responses to consultation

8 We received 11 responses to CP 125 from a variety of sources, including industry bodies, insurers and current members of the credit industry. We are grateful to respondents for their submissions.

9 There was general support among respondents to CP 125 for requiring all credit licensees to meet the same compensation requirements, unless they are specifically exempted by legislation from the need to hold PI insurance.

10 Generally, there was also agreement among respondents for our proposed minimum and maximum levels of cover, with some exceptions. The issue of the amount of cover credit licensees should hold is discussed further in Section B.

11 As part of our proposals on scope of cover, we proposed that an adequate PI insurance policy should include a period of automatic run-off cover, that is, a term of the policy providing for an automatic extension of cover for a specified period of time, which is triggered if the policy holder either becomes insolvent or retires. This kind of extension of cover is highly

desirable, from a consumer protection perspective, in maximising the chance that claims will be met even if brought to the insurer's notice after the business has ceased operating. We received a wide range of feedback on whether such cover is presently available in the market to the credit industry, and this issue is discussed in more detail in Section B.

12 Respondents to CP 125 also made a number of other helpful comments in relation to other specific aspects of the proposed PI insurance requirements; these are addressed in Section B.

B Our PI insurance requirements

Key points

Generally, there was support among respondents to CP 125 for our proposed approach to administering the compensation requirements, including proposals about the amount of cover credit licensees should hold.

Respondents expressed mixed views about the availability of run-off cover for the credit industry. Based on the feedback we received, we propose to adopt a flexible approach in relation to this requirement.

We also received comments in relation to other specific aspects of the proposed PI insurance requirements, including PI insurance cover for credit representatives, and requiring additional cover for non-consumer claims. These issues are discussed further in this section.

Overall approach

13 There was general support among respondents to CP 125 for our proposed approach to compensation requirements for credit licensees, including that we should apply the same requirements to all licensees unless they are specifically exempted by legislation from the requirement to hold PI insurance.

ASIC's response

We think that setting uniform requirements for all credit licensees that require PI insurance is the simplest approach for credit licensees to implement, and will ensure consistency of coverage among different sectors of the credit industry. We think that there is still sufficient flexibility in the PI insurance requirements to be workable for businesses of varying type and size. Where a business considers that the standards we have put in place in relation to PI insurance are not appropriate, it may apply for approval of alternative arrangements.

Amount of cover

14 Generally, responses were positive in relation to our proposed minimum and maximum levels of cover.

15 While a small number of respondents expressed a preference for a minimum level of cover of $1 million, the majority of respondents considered $2 million to be the more appropriate minimum level of cover. One respondent advocating $1 million as the more appropriate level was concerned that very small businesses might find it difficult to meet the cost of higher levels of cover.

16 A small number of respondents also disagreed with setting a capped maximum level of cover of $20 million, with one respondent stating that this level of cover would be difficult for smaller businesses to obtain.

17 Two respondents also expressed a preference that we not cap the maximum required cover, stating that, if licensees assess that they require higher levels of cover, their PI insurance policy should include this. However, we also received feedback that it is appropriate to set a cap at this level, as PI insurance becomes very difficult to obtain from a single insurer at the $20 million level, and licensees requiring more than $20 million cover might need to obtain layers of cover from a variety of insurers, at greater expense.

> *ASIC's response*
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> Overall, we are satisfied that a minimum level of cover of $2 million and a cap of $20 million are appropriate, and have set these levels in our final policy.
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> Where individual licensees consider that, due to the nature of their business, they require a lower level of cover than $2 million, and there is a legitimate reason for not meeting the general requirements, they may approach us for relief.
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> In relation to concerns that small businesses would not be able to obtain PI insurance in the range of $20 million, our set maximum, we note that only larger businesses would be required to obtain cover at the higher levels. This is because licensees are required to assess the level of cover they require on a sliding scale according to their expected revenue from credit services provided to consumers. It is unlikely that a small credit licensee following our guidance would assess its required coverage in the range of $20 million.
>
> We think that respondents make a valid argument in contending that licensees should obtain as much cover as they require, so a maximum level of cover is not required. However, we have also taken into account concerns about the availability of cover at levels above $20 million. Overall, we think that setting a maximum level of cover will assist licensees to comply with the compensation requirements without undermining access for consumer claims. If very large businesses assess the amount of cover they require at greater than $20 million, and can obtain this, they may still do so as part of their own risk management strategy.

Run-off cover

18 As part of our proposals on scope of cover, we proposed that an adequate PI insurance policy should include a period of automatic run-off cover, that is, a term of the policy providing for an automatic extension of cover for a specified period of time, which is triggered if the policy holder either becomes insolvent or retires. This kind of extension of cover is highly

desirable, from a consumer protection perspective, in maximising the chance that claims will be met even if brought to the insurer's notice after the business has ceased operating.

19 However, from feedback to CP 125, we are concerned that not all credit licensees will be able to obtain run-off cover and that, where run-off cover is available, this will not cover cases of insolvency. We understand that run-off cover has been reasonably readily available to certain sectors of the credit industry, primarily through membership of insurance schemes. However, we believe it may be more difficult for businesses to obtain run-off cover on an individual basis.

ASIC's response

Given that some parts of the credit industry are currently able to access automatic run-off cover, and there are important consumer protection benefits from including such cover in a PI insurance policy, we do not wish to discourage any licensee from obtaining run-off cover. However, as it may also be difficult for other parts of the industry to obtain run-off cover, a flexible approach is required.

For this reason, we have modified our final policy to require credit licensees to make reasonable efforts to obtain automatic run-off cover: RG 210.30. This would not need to cover cases of insolvency.

Licensees will be required to document the steps they take to seek run-off cover, and provide on request evidence of attempts made. In judging whether a licensee has made reasonable efforts, we will have regard to:

- whether more than one insurer has indicated that it is not prepared to offer automatic run-off cover to the licensee in question; or
- if automatic run-off cover has been offered to the licensee, whether the cost of obtaining such cover would be disproportionately expensive in relation to the licensee's expected business revenue.

Covering credit representatives

20 There was concern among some respondents (generally industry participants) at the requirement in our draft regulatory guide that an adequate PI insurance policy should not only cover claims against licensees but also against their credit representatives. Some respondents thought that the cost of obtaining such a broad policy could be prohibitive, or that insurers would be reluctant to cover credit representatives that are authorised by more than one licensee.

21 Under the National Credit Act, a licensee is required to have in place adequate arrangements for compensating persons for loss or damage suffered

because of a contravention of that Act by either the licensee *or* its representatives: s48. This provision supports Pt 2-3 Div 2 of the National Credit Act, which assigns liability for the conduct of a credit representative to their licensee, whether or not a representative's conduct is within the authority of the licensee.

ASIC's response

We think that the clear legal responsibility of credit licensees for their representatives provides little scope to depart from the general position that an adequate PI insurance policy must cover claims against both a licensee and its representatives.

However, we have attempted to find a workable solution to the problem of obtaining sufficient PI insurance to cover representatives. Our regulatory guide states that the credit licensee's PI insurance 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: RG 210.27(b), Note 2.

Where possible, credit licensees should ensure non-employee representatives have adequate PI insurance coverage before authorising them.

Assessing the amount of cover required for licensees with 'mixed' business

22 Under the credit legislation, credit licensees that engage in both lending and non-lending credit activities will be required to hold PI insurance (unless the licensee only provides credit services in relation to its own credit contracts: reg 12(3)(d)). Some respondents to CP 125 expressed the view that, in assessing the amount of cover they require, such licensees should only be required to take into account the non-lending aspects of their business.

23 RG 210 states that the following considerations are relevant in deciding what is an adequate amount of cover (RG 210.20):

(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.

ASIC's response

We consider that the guidance we have provided on assessing the amount of cover required is reasonable and directs licensees to consider only those aspects of their business that are reasonably likely to expose them to potential claims.

It is not desirable for us to limit the areas to which credit licensees should have regard in assessing their risk profile. Licensees

> should assess all areas of their business to determine their potential exposure to consumer claims. In doing so, it may be that they determine that the non-lending aspect of their business requires greater cover than the lending aspect of their business.

Requiring additional cover for non-consumer claims

24 The draft RG attached to CP 125 stated that:

> 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.

25 Some respondents to CP 125 expressed concern that this requirement would mean that they would be required to hold two separate PI insurance policies, one for consumer claims and one for other claims, and that this would not be possible to obtain.

> *ASIC's response*
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> It is not our intention that credit licensees be required to hold two separate policies, but that, if licensees think they may have a potential exposure to non-consumer claims, they should assess this risk separately, and obtain an amount of cover that is adequate to meet their exposure to both consumer and non-consumer claims.
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> We have clarified our approach in our final guidance: see RG 210.23.

Appendix: List of non-confidential respondents

- Advantedge Financial Services
- AFG
- Aussie
- Australian Finance Conference
- Financial Planning Association
- Financiers Association of Australia/Min-it Software
- GE Capital
- Insurance Council of Australia
- Mortgage & Finance Association of Australia
- National Insurance Brokers Association
- Optimum Insurance Services