



ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

ASIC Implementation of the National Credit Act: Compensation Requirements

March 2010

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals for the new regulatory obligations in relation to compensation requirements for credit licensees under the *National Consumer Credit Protection Act 2009*.

What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposals for new regulatory obligations in relation to compensation requirements for credit licensees under the *National Consumer Credit Protection Act 2009*.
- 2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:
 - maintaining, facilitating and improving the performance of the financial system and entities in it;
 - promoting confident and informed participation by investors and consumers in the financial system; and
 - administering the law effectively and with minimal procedural requirements.
- 3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
 - the likely compliance costs;
 - the likely effect on competition; and
 - other impacts, costs and benefits.

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A Introduction

Background

National credit legislation

- 4 The *National Consumer Credit Protection Act 2009* (National Credit Act), the *National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009* (Transitional Act), the *National Consumer Credit Protection (Fees) Act 2009* (Credit Fees Act), the *National Consumer Credit Protection Regulations 2010* (National Credit Regulations), and the *National Consumer Credit Protection (Transitional and Consequential Provisions) Regulations 2010* (Transitional Regulations) together outline a new national consumer credit regime. The new regime:
- (a) gives effect to the Council of Australian Governments' (COAG) agreements of 26 March and 3 July 2008 to transfer responsibility for regulation of consumer credit, and a related cluster of additional financial services, to the Commonwealth; and
 - (b) implements the first phase of a two-phase Implementation Plan to transfer credit regulation to the Commonwealth, endorsed by COAG on 2 October 2008.
- 5 The Consumer Credit Protection Reform Package establishes the key components of the proposed national credit regime, which include:
- (a) a comprehensive licensing regime for those engaging in credit activities via an Australian credit licence (credit licence) to be administered by the Australian Securities and Investments Commission (ASIC) as the sole regulator;
 - (b) industry-wide responsible lending conduct requirements for credit licensees;
 - (c) improved sanctions and enhanced enforcement powers for the regulator; and
 - (d) enhanced consumer protection through dispute resolution mechanisms, court arrangements and remedies.
- 6 The RIS attached to the Explanatory Memorandum to the National Consumer Credit Protection Bill 2009 (Explanatory Memorandum)¹ discusses problems in relation to unscrupulous market practices in the

¹ Available at:

http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fems%2Fr4180_ems_668afa2a-603f-4c9c-ba71-f405d60faad3%22

provision of credit and related services that led to the instigation of the new national consumer credit regime (paragraph 9.88), as well as assessing the regulatory impact of the licensing of operators as the best means to raise standards of conduct in the industry (paragraphs 9.105–9.106).

Obligations on licensees under the national credit legislation

7 The reforms introduce a comprehensive national licensing regime, which is to be distinguished from the current regulation of financial services under the *Corporations Act 2001* (Corporations Act).

8 Among other obligation, a credit licensee must:

- (a) have adequate arrangements for compensating persons for loss or damage suffered because of a contravention of the National Credit Act by the licensee or its representatives (see s48(1));
- (b) do all things necessary to ensure that the credit activities authorised by the credit licence are engaged in efficiently, honestly and fairly (see s47(1)(a)); and
- (c) have adequate risk management systems (see s47(1)(i)(ii)).

9 ‘Adequate arrangements’ for compensation must consist of professional indemnity (PI) insurance that is adequate (National Credit Regulations, reg 12(1)) unless ASIC has approved an alternative arrangement (s48(2)), or a licensee is specifically exempted from the requirement to hold PI insurance under the credit legislation. In relation to the latter, entities regulated by the Australian Prudential Regulation Authority (APRA), authorised deposit-taking institutions (ADIs) and lenders that do not engage in any non-lending credit related activities are all exempted from the requirement to hold PI insurance (reg 12(3)).

10 Regulation of consumer credit in the new regime will be the responsibility of ASIC.

Regulatory impact of the national credit legislation

11 The regulatory impact of the licence obligations established under the National Credit Act was assessed in the RIS attached to the Explanatory Memorandum.

12 In summary, that RIS found:

- (a) The main group affected is industry participants who will need to become holders of a credit licence in order to continue engaging in credit activities.
- (b) The most significant impact will be on those who only conduct business in states or territories where there is currently no licensing or

registration scheme. It can be anticipated that these businesses will face significant transitional costs.

- (c) Licensing will involve one-off costs associated with applying for a credit licence, together with ongoing fees for lodging various documents. There will also be costs of complying with the ongoing obligations associated with the licence, including, in particular:
 - (i) training and supervision costs; and
 - (ii) maintaining adequate compensation arrangements (e.g. PI insurance).

- 13 The size of the affected population was also addressed in the RIS attached to the Explanatory Memorandum. However, there is some degree of uncertainty about the size and structure of the market, as there is currently no nationally consistent registration or licensing framework to provide that information.
- 14 The licensing system existing in Western Australia provides some guidance as to the size of the regulated population. Western Australia has reported that there are approximately 190 credit providers registered in that jurisdiction, of whom approximately 100 operate nationally. These figures do not include ADIs registered under the *Banking Act 1959* (approximately 500 nationally) that may operate in Western Australia, as ADIs are not required to be licensed under the Western Australian legislation. However, ADIs are regulated by APRA and therefore under the National Credit Act they will be exempt from the compensation requirements.
- 15 In addition to credit providers, the new regulatory framework also covers persons whose business involves providing credit services such as suggesting consumers enter into credit contracts and consumer leases, or assisting them to enter into credit contracts and consumer leases. Such participants are primarily (though not exclusively) comprised of finance brokers. There are approximately 3,000 licensed finance brokers in Western Australia and, of those, around 200 have addresses outside Western Australia.
- 16 Persons other than brokers that are part of the credit supply chain and may be covered by aspects of the new regulatory framework include aggregators and mortgage managers. It is estimated that between one and two hundred persons fall into those groups. Persons whose business is the collection of debts (either as assignee or as agent of a credit provider) will also be subject to aspects of the proposed regime, including licensing.
- 17 Based on the above, the RIS attached to the Explanatory Memorandum estimated that the affected population, in terms of industry participants, could be as high as 10,000 nationally.

- 18 There are some overlaps between the new credit licensing regime and the existing Australian financial services (AFS) licensing regime administered by ASIC. It is likely that some of the affected parties are already subject to regulation by ASIC in some way because they hold an AFS licence.
- 19 In relation to the size of the population that will specifically be affected by the requirement to hold PI insurance, as noted in paragraph 9, APRA-regulated entities, ADIs and lenders that do not engage in any non-lending credit related activities are all exempted from the requirement to hold PI insurance (reg 12(3)). This means that those mostly affected by the requirement to hold PI insurance will include:
- (a) brokers;
 - (b) other credit assistance providers, including AFS licensees that provide credit assistance as part of broader financial advice; and
 - (c) credit intermediaries, such as credit aggregators.

What this RIS is about

- 20 This RIS assesses the regulatory impact of ASIC's proposals associated with implementation of the credit legislation. It does not deal with the decision to require credit providers to be licensed, as this is an obligation imposed under the National Credit Act. Rather, this RIS assesses the regulatory impact of those decisions within ASIC's discretion which are necessary for implementation of the credit legislation by us.
- 21 Because the national credit regime is new, we will continue to monitor the impact of our regulation on the industry, and will revise our approach if necessary.

Assessing the problem

Background to the problem

New legislative requirement to hold PI insurance

- 22 Under the National Credit Regulations, credit licensees are required to hold PI insurance that is adequate having regard to:
- (a) the licensee's membership of an approved external dispute resolution EDR 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 in relation to the licensee engaging in a credit activity, including:
 - (i) the volume of business involved in the credit activity;
 - (ii) the number and kind of clients;
 - (iii) the kind, or kinds, of credit activities involved; and
 - (iv) the number of representatives of the licensee.

Existing State regulation

23 Currently, the states and territories regulate credit and consumer lending through the Uniform Consumer Credit Code (UCCC). Victoria, New South Wales, Western Australia and the ACT have limited broker-specific regulation in addition to the UCCC. Only Western Australia imposes an obligation that a credit provider must hold PI insurance. In Western Australia a Licensed Credit Provider is required to hold PI insurance that meets minimum requirements specified by the Commissioner for Consumer Affairs, and to submit with their licence application a certificate of currency to demonstrate the adequacy of their PI insurance with their licence application. The requirements set by the Commissioner for Consumer Affairs specify a minimum level of cover Licensed Credit Providers must hold (at least \$1 million), as well as certain terms that must be in the policy.

Problems

24 The problem that ASIC's guidance seeks to address is one of regulatory failure as a result of the failure of the National Credit Regulations to set clear standards for compliance with the requirement for credit licensees to hold PI insurance, as described above in paragraph 22.

25 While the legislation directs licensees to assess the level and type of PI insurance they may require by reference to their potential liability through the kind of business they operate, and the claims that may be made directly to them or through an EDR scheme, this obligation is still relatively high level in nature. There is currently no accepted standard for what constitutes adequate arrangements for compensation, or what type and level of PI coverage is appropriate for those in the credit industry, as this requirement has not previously been imposed consistently across the group concerned.

26 The potential consequences of this lack of guidance in the legislation are outlined below.

Industry confusion

27 Given the requirement to hold PI insurance is a new obligation for most operators within the credit industry, there may be confusion as to how to comply with the requirement to hold 'adequate' PI insurance. The credit

legislation does not set any concrete guidelines on the amount of cover that a PI insurance policy should provide for in order to be considered 'adequate'; nor does it indicate what kinds of policy terms should be included in an 'adequate' policy document.

- 28 As we have not previously regulated this population, it is difficult to quantify the scale of the problem. However, in our regulatory experience, industry participants find it more difficult to comply with rules that are very broad in nature, and, while they do not wish to be subjected to rules that are overly prescriptive and therefore inflexible, the certainty provided by detailed guidance on how to comply with high-level requirements is valued (see, for example, paragraph 39² of ASIC's RIS accompanying Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees*(RG 126)). The impact of this problem on this group is therefore likely to be high, in terms of time spent determining how to comply with the law.

Consumer protection risks

- 29 Where consumers suffer loss resulting from a breach of the credit legislation by a credit licensee or its representatives, they may require a monetary payment to compensate for the loss. Consumers may be able to establish that they have suffered a loss that requires monetary compensation through the findings of the licensee's own internal dispute resolution processes, through the determination of an EDR scheme, to which all credit licensees and representatives are required to belong, or through the judgment of a court.
- 30 Without holding a PI insurance policy that allows for such claims to be made, and that provides a sufficient amount of cover, a credit licensee may not have the means to provide this compensation to consumers.
- 31 As the area of credit has not previously been regulated in a consistent way, we are not aware of any data available recording how many consumers have previously suffered losses relating to credit that have required compensation, or the adequacy, or otherwise, of PI insurance that operators have held in the past. Therefore, we have no data to suggest whether or not this has historically been a problem.
- 32 We expect that a prudent credit licensee would seek to minimise the risk that it will be exposed to losses it is unable to meet from its existing financial resources. We are concerned, however, that, since this will be a new requirement for many in the industry, there is a concern that licensees may not choose the right level of cover. For example, not all licensees will be able to anticipate the amount of PI insurance they will require, or the scope of the terms that a policy should cover. These licensees are likely to obtain from insurance brokers whatever standard cover is provided in the market at

² Available at: [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg126-1.pdf/\\$file/rg126-1.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg126-1.pdf/$file/rg126-1.pdf)

the lowest possible cost, without negotiating any amendments to the standard terms. This may not result in a policy that is adequate to ensure that licensees meet their consumer protection obligations, leaving consumers without means of compensation.

- 33 As credit providers have not previously been regulated, we are not able to estimate the likelihood that a licensee will obtain inadequate cover, however the potential impact on consumers who become uncompensated is likely to be medium to high.

Impediments to ASIC administrative action

- 34 Under s55 of the National Credit Act, ASIC may suspend or cancel a credit licensee's licence for matters including that a licensee has contravened one of the 'general conduct obligations' listed in s47, comprising the requirement to have in place adequate arrangements for compensating consumers.

- 35 It may be difficult for us to successfully take action to suspend or cancel a credit licence on the grounds that a licensee has not satisfied the requirement to have in place adequate compensation arrangements unless we first clearly set out our expectations in relation to the level and scope of cover that credit licensees should have in place.

- 36 In addition, while credit licensees are generally required to hold PI insurance, the National Credit Act allows licensees to apply to ASIC for approval of some alternative arrangement for compensating consumers (e.g. a legally enforceable guarantee of payment of all claims from a parent company): s48(2). In approving such arrangements, we must have regard to whether they will provide coverage that is as adequate as a compliant PI insurance policy: reg 12(2). The existing provisions in the law do not provide clear enough guidelines as to what constitutes an adequate PI insurance policy to allow ASIC to make a decision whether to approve any proposed alternative arrangements.

- 37 Based on our experience with AFS licensees, our expectations are that the proportion of credit licensees who would seek approval of an alternative arrangement is likely to be small, however the impact on those licensees is likely to be medium to high.

Objectives of government action

- 38 In relation to implementation of the Consumer Credit Protection Reform Package in general, our proposals seek to balance ASIC's objectives to:
- (a) maintain, facilitate and improve the performance of the financial system and entities in it;

- (b) promote confident and informed participation by investors and consumers in the financial system; and
- (c) administer the law effectively and with minimal procedural requirements.

39 The compensation requirements in the National Credit Act are designed to enhance consumer protection and market integrity by ensuring that credit licensees have adequate arrangements in place to compensate consumers for loss suffered as a result of a breach of the credit legislation by licensees or their representatives.

B Options and impact analysis

40 This section considers options for providing greater clarity in relation to what constitutes an ‘adequate’ PI insurance policy.

41 The analysis in this section has been informed by feedback received in response to the consultation papers ASIC has released on the issue of compensation requirements for credit licensees:

- (a) Consultation Paper 111 *Compensation and financial resources arrangements for consumer credit* (CP 111) (July 2009); and
- (b) Consultation Paper 125 *Compensation requirements for credit licensees: Further consultation* (CP 125) (November 2009).

A summary of this feedback is provided in the Consultation section (see paragraph 85).

Options

42 Possible options are:

- **Option 1:** ASIC sets minimum standards that apply to all credit licensees required to hold PI insurance;
- **Option 2:** ASIC sets different standards for credit licensees according to the type of business in which they engage; and
- **Option 3:** ASIC does not provide any guidance.

Impact analysis

Option 1: ASIC sets minimum standards that apply to all credit licensees that are required to hold PI insurance

Description of option

43 Under this option, we would produce a new regulatory guide setting out detailed guidance on our expectations in relation to an ‘adequate’ PI insurance policy, including:

- (a) how a credit licensee should assess the amount of cover it will require under the policy—that is, credit licensees that are required to hold PI insurance would be required to assess the amount of PI insurance that 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).
- (b) the scope of the cover that should be provided for under the terms of the policy, to ensure the policy covers all of the types of claims that a licensee might be required to meet under the credit legislation, including:
 - (i) EDR scheme awards and awards made by the Federal Court under the proposed small claims jurisdiction (i.e. up to \$40,000);
 - (ii) losses caused by the conduct of representatives;
 - (iii) fraud and dishonesty by agents and representatives;
 - (iv) claims for misrepresentations about services; and
 - (v) run-off cover (i.e. cover that applies where the licensee retires or sells the business, so that consumers can continue to bring claims for a specified period), where reasonably available to the licensee, without excessive expense (with ASIC to determine whether a particular licensee has made reasonable efforts to obtain this type of cover based on the licensee's documentation of its efforts to obtain it); and
- (c) guidance that the policy should not contain any individual terms and conditions that would undermine the effect of the policy as a whole, such as excesses and exclusions, where these would risk exposing the licensee to uninsured losses from consumer claims it cannot meet.

44 These requirements would apply equally to all credit licensees, unless they are exempted from the requirement to hold PI insurance by legislation, or have alternative arrangements approved by ASIC, regardless of the kind of credit activities in which they engage. However, setting the amount of cover required on a sliding scale would allow a degree of flexibility for businesses, with smaller businesses potentially able to take out less cover than larger businesses, according to their relative exposure to liability risk.

45 In setting the minimum level of cover associated with this option, we considered two options:

- (a) firstly, a minimum cover of \$2 million to align with the requirements imposed on AFS licensees, which are required to hold PI insurance in relation to their financial services activities under reg 7.6.02AAA of the *Corporations Regulations* 2001. This figure was set by us in 2007, at the recommendation of a report commissioned by ASIC on the state of the PI insurance market: *Compensation arrangements for financial services licensees: Research into the professional indemnity insurance market* (REP 107). After reviewing APRA claims data relating to PI insurance claims across all industries, the consultant concluded that a minimum cover of \$2 million would cover 90% of all claims, with more

cover required for businesses with greater than \$2 million annual revenue. The licensing obligations imposed on AFS licensees, including the requirement to hold PI insurance, are very similar to those imposed on credit licensees; and

- (b) secondly, a minimum cover of \$1 million, as imposed on brokers in Western Australia. We understand that this requirement has been in place since 2005.

46 We sought feedback on both options in CP 111 and CP 125. As described further in the Consultation section (paragraph 85), the majority of respondents favoured the higher limit of \$2 million as more appropriate for the types of claims to which licensees are likely to be exposed. One insurance broker also expressed concern that \$1 million would not be sufficient to meet both the costs of compensating consumers and the associated legal costs. As a result of this feedback, we have determined that this option should include a minimum level of cover of \$2 million.

Impact on industry

47 Industry participants that would be particularly affected by this option are:

- (a) credit licensees and their representatives; and
- (b) insurers that will provide PI insurance to credit licensees.

Credit licensees

48 For credit licensees, this option would give a degree of certainty as to how they can meet their new legal obligation to have in place adequate arrangements for compensating consumers. We think that the guidance proposed under this option would be of great assistance to licensees in making their insurance arrangements, and allow them to plan ahead to meet their compliance requirements.

49 Given that this option would involve setting minimum standards, it is possible that following our guidance would lead some businesses to obtain more comprehensive cover than they would otherwise have judged necessary. However, by ensuring that they have a PI insurance policy that covers all the types of claims a credit licensee might reasonably be expected to meet under the credit legislation, these requirements minimise the risk that credit licensees will be exposed to uninsured losses that they cannot meet.

50 While there would be some risk that certain credit licensees would find it difficult to obtain PI insurance that meets the minimum standards, we think that this risk is relatively low, and would generally be isolated to businesses with a poor claims history, or businesses that cannot demonstrate good compliance practices to their insurer. On the other hand, if there are legitimate reasons why the PI insurance requirements set by us are not appropriate for a particular licensee's business, the proposed regime allows

flexibility for those licensees to apply to us for approval of alternative arrangements, so long as these would achieve a similar standard of consumer protection to PI insurance. In consulting on this option, we did not receive any significant feedback that PI insurance complying with the minimum standards described in this option is not presently available in the market: see the Consultation section, paragraph 85.

51 In relation to cost:

- (a) REP 107 found that PI insurance premiums tend to cost between 0.65–2% of the insured’s revenue. While the insurance market varies from time to time, we think this estimate is likely to be indicative for credit licensees.
- (b) This option would also generate compliance costs by requiring credit licensees to understand the requirements of our regulatory guide; however, these are likely to be low. In addition, this option is also likely to reduce compliance costs, compared with ASIC providing no guidance, by enabling licensees to determine more quickly what type of PI insurance policy they need to obtain.
- (c) In addition, licensees will need to record the process by which they determined what level of cover is appropriate for them, as well as the process of making reasonable attempts to seek run-off cover. However, this compliance cost would be incurred under any of the options assessed in this RIS, because s47(k) requires licensees to keep a written plan documenting the arrangements they make to comply with their licensing obligations.

52 In relation to the effect of this option on various sectors of the credit industry, as noted in paragraph 17, the RIS attached to the Explanatory Memorandum estimated that the affected population, in terms of industry participants, could be as high as 10,000 operators nationally, and the impacts were likely to vary according to the type of business involved.

53 We are not aware of how many of those operators in the market already hold PI insurance, and, if they do, the extent to which those policies already meet the requirements proposed as part of this option. However, for licensees that already hold PI insurance that is considered adequate within the terms of this option, no new costs would be imposed.

54 For credit licensees that are already AFS licensees, and are required to hold PI insurance in relation to their financial services activities under reg 7.6.02AAA of the *Corporations Regulations 2001*, this option would have a different impact depending on the amount of PI insurance they already hold. These licensees would need to assess their PI insurance needs in relation to their credit activities, and, depending on the level of cover they already hold, they might decide either that they need to increase the amount of cover they currently hold, or that they do not need additional cover. As with all credit

licensees, however, those holding both an AFS and credit licence would need to ensure that the terms of their PI insurance policy allowed for claims relating to breaches of the credit legislation, and otherwise met the requirements specified in paragraphs 43(a)–43(c).

55 As discussed in paragraph 23, licensees that were formerly licensed under the Western Australian broker licensing regime were previously subject to the requirement to hold a minimum of \$1 million cover, rather than a minimum of \$2 million. Therefore, implementing Option 1 might mean that some Western Australian brokers would need to take out additional cover, at additional cost. However, while the Western Australian regime set similar requirements in relation to scope and terms of a policy as proposed under Option 1, the Western Australian scheme also contained the following additional requirements, i.e.:

- (a) a minimum 12 months' automatic run-off cover (as opposed to ASIC's flexible approach of requiring this type of cover where reasonably available);
- (b) a requirement that the PI insurance policy must endorse the Western Australian Commissioner for Consumer Affairs as an interested party, so the Commissioner would be allowed to initiate a period of run-off cover, or be notified in the event that any of the following events occur:
 - (i) cancellation and/or lapse of the policy;
 - (ii) non-renewal of the policy;
 - (iii) a claim being made on the policy.

These policy terms would not be required under Option 1; therefore, the requirement imposed on some former Western Australian brokers to obtain greater cover could be mitigated by being subject to slightly less onerous requirements in terms of the scope and coverage of the PI insurance policy.

56 As noted at paragraph 13 above, the size of the affected population is unclear, so ASIC does not have any information on the numbers of affected small business or how many employees they have. Smaller licensees would be likely to find it more difficult to absorb any additional costs incurred where their current PI insurance arrangements would not meet the adequacy requirements of this section. In general, it is possible that some smaller businesses might decide they do not have the resources to satisfy the licensing requirements of the National Credit Act, including the PI insurance requirements set by ASIC. However, we think that a number of factors may mitigate this:

- (a) We are aware that many smaller businesses currently operating in the credit industry (e.g. smaller finance and mortgage brokers) have been able to arrange themselves into insurance schemes through their industry bodies, and obtain affordable PI insurance in this manner.

- (b) We have received direct feedback from insurers that the new demand for PI insurance for credit licensees is likely to increase competition and open up the range of insurance available to the industry, including the possibility of other innovative arrangements such as the schemes currently available to smaller brokers.

57 Licensees that currently do not hold PI insurance would face the cost of obtaining this for the first time. However, this cost results from the requirement to hold PI insurance under the National Credit Act, rather than being a cost imposed by ASIC's regulatory activity.

Insurers

58 Insurers may incur some initial costs in understanding the requirements of the minimum standards imposed under this option, and in developing the capability to provide PI insurance policies that meet these requirements. However, in the longer term, the fact that the credit legislation generally requires licensees to hold PI insurance means that insurers are likely to benefit from increased demand for PI insurance for this industry, which has generally not been subject to this requirement under state regulation. Revenue generated from this new demand is likely to be greater than any implementation costs incurred.

Impact on consumers

59 The Explanatory Memorandum set as one of the objectives of the new national regulation of credit the need to ensure that borrowers who suffer losses because of a breach of their obligations by licensees are able to obtain compensation: paragraph 2.14.

60 Setting minimum standards for credit licensees' PI insurance maximises the potential that the cover that licensees take out will be 'adequate' in the sense that there is a low risk that losses sustained by consumers could not be compensated for by a credit licensee because of a lack of available financial resources. If we did not set such minimum standards, there is a risk that some licensees would not take out sufficient cover to meet this aim.

61 Setting uniform standards to apply to all credit licensees required to hold PI insurance is also important from a consumer perspective, as it ensures that consumers are able to take advantage of the same protections no matter which type of credit service they are being provided with.

62 This option would not impose any direct costs on consumers. Given that this is a new regime, and we do not yet have a complete understanding of the current makeup of the credit industry, we are uncertain about the drivers of competition in this market. Therefore, it is difficult to predict at this stage whether any indirect costs are likely to be passed on to consumers, or

whether market competition is likely to lead industry to absorb the costs of implementing the new PI insurance requirements itself.

Impact on government

63 To implement this option, we would need to draft and release a new regulatory guide, setting out minimum standards for an adequate PI insurance policy. We have already received additional funding from Government to assist us to carry out policy work associated with the new regulation of consumer credit, and would not apply for further funding in relation to this work.

64 Undertaking this work would ultimately benefit ASIC in providing it with concrete guidelines by which to assess whether individual licensees are complying with their PI insurance requirements, as well as providing clear standards for assessing whether proposed alternative arrangements would afford similar consumer protection standards to PI insurance.

Option 2: ASIC sets different standards for credit licensees according to the type of business in which they engage

Description of option

65 While Option 1 involves setting uniform PI insurance requirements that apply to all credit licensees required to hold PI insurance under the credit legislation, under this option, we would set different PI insurance requirements for different types of businesses within the pool of licensees that are required to hold PI insurance.

66 In our view, the most logical way to divide credit businesses for the purposes of applying different PI insurance requirements is between those that are primarily lenders, and those that mostly undertake non-lending activities (e.g. assisting a consumer to apply for a credit contract, or performing intermediary services such as aggregating). As discussed in CP 125, this is because lenders are likely to be better placed than non-lenders to meet compensation claims from their existing financial resources, as they must already hold sufficient funds to carry on their lending activities, and because consumers that suffer a loss as a result of being supplied with credit may be compensated by other means than through the payment of money, such as through the variation of contractual terms.

67 Licensees that only engage in lending, or that only provide related credit services in relation to their own credit contracts, are exempt from the requirement to hold PI insurance (reg 12(3)(b)–(c)), so our guidelines on PI insurance will not be relevant for these licensees. However, licensees that undertake a mixed business of some lending and some additional non-related credit services are required to hold PI insurance. Under Option 2, we could set different requirements for:

- (a) credit licensees that are primarily lenders—that is, credit licensees that primarily provide credit, but cannot take advantage of the legislative exemption from the PI insurance requirement because they also engage in a small amount of non-lending credit services; and
- (b) credit licensees that primarily provide credit services.

68 Based on the reasoning that businesses that are primarily lenders will not require as much PI insurance as they are able to compensate consumers via other means, we would either:

- (a) set more lenient minimum standards for credit licensees that primarily provide credit; or
- (b) allow these licensees to self-assess their own PI insurance requirements.

69 In making this distinction, ASIC would need to set objective guidelines to enable licenses to assess to which category they belong. This would need to be done by setting a test based on the proportion of the licensee’s revenue that is derived from lending versus non-lending activities (e.g. if 70% or more of revenue was derived from lending, then a licensee would be considered to be primarily a lender for the purposes of our PI insurance requirements).

Impact on industry

70 Industry participants that would be particularly affected by this option are:

- (a) credit licensees and their representatives; and
- (b) insurers that will provide PI insurance to credit licensees.

Credit licensees

71 For credit licensees that mainly provide credit services, the impacts of this option would be very similar to those of Option 1, being a combination of:

- (a) the benefits of certainty as to how they can meet their obligation to hold adequate PI insurance, and ensuring that they have adequate financial resources to meet claims; and
- (b) the potential costs for some businesses, in requiring them to obtain more comprehensive cover than they might otherwise have judged necessary.

72 If we were to impose more lenient standards for credit licensees that are primarily lenders, this could potentially result in lower PI insurance costs for these lenders. For other licensees, the direct costs of obtaining PI insurance would be the same as for Option 1.

73 However, Option 2 may result in some licensees having difficulty in meeting their PI insurance requirements, and increased compliance costs, for example:

- (a) Licensees may be uncertain as to whether their business falls into the ‘primarily lending’ or ‘primarily non-lending’ category. Even if we set an objective test, based on the proportion of revenue derived from lending versus non-lending activities, we have received feedback that the proportion of revenue derived from different aspects of a mixed credit business can fluctuate greatly from year to year. The result of this would be that licensees might fall into different categories from year to year, and therefore be subject to different PI insurance requirements. This would not only be difficult from a compliance perspective, but would also compromise the continuity of coverage.
- (b) If we take the option of not specifying any particular PI insurance requirements for businesses in the ‘primarily lending’ category, this may lead to uncertainty among such businesses as to how they can meet their legal obligation to have in place adequate arrangements for compensating consumers.

Insurers

- 74 Whatever specific requirements we set in relation to the level and scope of cover, the primary obligation to hold adequate PI insurance is imposed on most credit licensees by the National Credit Act. Therefore, insurers would still receive similar benefits from this option as for Option 1 in terms of increased demand for PI insurance for this industry. It is possible, however, that licensees self-assessing their needs might judge that they require less cover than would be required under our requirements, leading to slightly less revenue for insurers under this option.

Impact on consumers

- 75 Given that one of the aims of the new national regulation of credit is to ensure that borrowers who suffer losses because of a breach of their obligations by credit licensees are able to obtain compensation (Explanatory Memorandum, 2.14), it is important to ensure that credit licensees hold sufficient PI insurance to minimise the risk of not having the financial resources to meet consumer claims. In our view, implementing Option 2 would involve a greater likelihood of some credit licensees not holding adequate PI insurance.
- 76 Some submissions to CP 111 expressed concern that some credit licensees might structure their business in order to fall into the ‘primarily lending’ category, and avoid more onerous PI insurance requirements. For example, the revenue earned from lending is significantly larger than the revenue from non-lending, and therefore it might be possible for a credit service provider to enter into a small number of loans and technically fall into the ‘primarily lending’ category. Such a licensee might not necessarily have sufficient financial resources to meet any consumer claims relating to the non-lending aspect of its business without holding adequate PI insurance.

77 This option would not impose any direct costs on consumers. As with Option 1, given that this is a new regime and we do not yet have a complete understanding of the current makeup of the credit industry, we are uncertain about the drivers of competition in this market. Therefore, it is difficult to predict at this stage whether any indirect costs are likely to be passed on to consumers, or whether market competition is likely to lead industry to absorb the costs of implementing the new PI insurance requirements itself.

Impact on government

78 As for Option 1, to implement this option, we would need to draft and release a new regulatory guide, setting out minimum standards for an adequate PI insurance policy. We have already received additional funding from Government to assist us to carry out policy work associated with the new regulation of consumer credit, and would not apply for further funding in relation to this work.

79 This option would potentially involve greater difficulty for us in assessing whether individual licensees are complying with their PI insurance requirements, as it would involve determining whether credit licensees have correctly identified which requirements apply to them, as well as deciding whether the PI insurance cover they have obtained is adequate. This is particularly true if we take the option of not specifying any particular PI insurance requirements for businesses in the ‘primarily lending’ category.

80 This option is likely to benefit us in reducing the number of cases of consumer hardship resulting from a licensee’s inability to provide adequate compensation and requiring ASIC assistance.

Option 3: ASIC does not provide any guidance

Description of option

81 Under this option, if the status quo remains, all credit licensees will be required to hold ‘adequate’ PI insurance, unless they are exempted by legislation, or we approve their alternative arrangements. However, licensees will only have the limited guidance provided in the legislation as to the level and scope of cover they should take out in order to comply with their obligations.

82 Although we would not set any particular requirements in relation to what constitutes an adequate PI insurance policy, we would encourage industry to develop its own policies on PI insurance requirements to fill this gap.

Impacts

83 In our view, this option is not realistic. Doing nothing will lead to confusion among credit licensees as to how they can meet their compensation

requirements. The credit industry is extremely diverse, and is not represented by one single industry body, which could logically take on the task of developing self-regulatory policy on PI insurance.

- 84 Instead, individual licensees would be left to make their own judgment about their requirements. As the National Credit Act is a new regulatory regime and the number and size of potential licensees is unknown at this stage, the actual level of cover that licensees will choose is unknown, however licensees are likely to obtain from insurance brokers whatever standard cover is provided in the market at the lowest possible cost, without negotiating any amendments to the standard terms that would be necessary to take into account the particular risks in relation to credit activities. This would have a potentially high impact on consumers, as it may not result in a policy that is adequate to ensure that licensees meet their consumer protection obligations, and the range of claims to which they may be exposed, leaving consumers without means of compensation, and could compromise the consumer protection rationale of the credit legislation in imposing the requirement to hold adequate PI insurance.

C Consultation

CP 111

- 85 We released CP 111 in July 2009, consulting on proposals in relation to how we should administer the compensation requirements for credit licensees.
- 86 Our proposals in CP 111 were based on an early exposure draft of the National Credit Regulations (released by Treasury on 27 April 2009). This draft of the regulations contained exemptions from the requirement to hold PI insurance for ADIs and APRA-regulated entities; however, lenders that do not engage in any non-lending credit related activities were not exempted, as is the case in the final version of the regulations.
- 87 We therefore 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); and
 - (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.
- 88 CP 111 proposed two tests for determining who is a 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).
- 89 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.
- 90 Generally, there was support for the approach proposed in CP 111, particularly for the approach we proposed to take in relation to non-lenders. However, in relation to lenders, 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.

91 In relation to applying a test to determine whether a licensee is primarily a lender or a non-lender for the purposes of the PI insurance requirements, respondents argued that this would be too difficult to apply in practice, and that a more 'clean-cut' approach should apply whereby all licensees not formally exempted from the requirement to hold PI insurance would need to meet the same minimum standards.

CP 125

- 92 A further exposure draft of the regulations was released by Treasury on 20 November 2009, including an exemption for lenders that do not engage in any non-lending credit related activities. As this represented a significant change to the range of credit licensees that would be required to hold adequate PI insurance, we consulted on new proposals in CP 125:
- (a) that all credit licensees should be subject to the same requirement to hold a minimum amount of PI insurance, unless specifically exempted from the requirement by legislation;
 - (b) that licensees that require PI insurance should assess the amount they need 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); and
 - (c) that licensees should ensure that their policies also meet our requirements relating to policy terms and scope, as set out in a new regulatory guide.
- 93 We received 11 submissions from credit service providers, lenders, insurance brokers, insurers and credit and insurance industry bodies.
- 94 As with the earlier consultation paper, 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 from the need to hold PI insurance by legislation.
- 95 Generally, there was also agreement among respondents for our proposed minimum and maximum levels of cover.
- 96 Two respondents expressed a preference for the minimum cover to be set at \$1 million rather than \$2 million. The first, an industry body representing insurers thought that \$1 million would be sufficient as long as licensees also had additional cover for other claims not relating to consumer credit; the second, a body representing small financiers was concerned that the cost of

PI insurance should not exclude smaller businesses from the market (we note that small lenders are likely to be covered by the exemption from the requirement to hold PI insurance). We note that licensees that consider our PI insurance requirements to be too onerous may apply to have alternative compensation arrangements approved.

- 97 In relation to the maximum level of cover required, one respondent (a large aggregator) preferred a cap of \$10 million rather than \$20 million, stating that it could be difficult for many licensees to obtain a higher limit of cover. However, we also received feedback from insurance brokers that, while not as widely available as lower levels of cover, PI insurance cover of over \$10 million is available in the market for the smaller group of licensees that would require it.
- 98 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.
- 99 However, feedback received in response to CP 125 from a variety of different respondents, including credit service providers, insurance brokers and insurers raises our concerns 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.
- 100 Given that some parts of the credit industry are currently able to access 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 take reasonable steps to obtain run-off cover. Licensees will be required to document such steps, and produce evidence of attempts made on request by ASIC.

D Conclusion and implementation

Conclusion and recommended option

- 101 We recommend Option 1—that is, we recommend ASIC produce a new regulatory guide setting out detailed guidance on its expectations in relation to an ‘adequate’ PI insurance policy, including:
- (a) how a credit licensee should assess the amount of cover it will require under the policy, according to a sliding scale starting with a set minimum required amount of cover, and rising according to the licensee’s actual or expected revenue from credit activities relating to consumers, up to a capped maximum;
 - (b) the scope of the cover that should be provided under the terms of the policy, to ensure the policy covers all of the types of claims that a licensee might be required to meet under the credit legislation, including claims for loss suffered as a result of breaches by the licensee’s representatives, and compensation awards made by an EDR scheme; and
 - (c) guidance that the policy should not contain any individual terms and conditions that would undermine the effect of the policy as a whole, such as excesses and exclusions, where these would risk exposing the licensee to uninsured losses from consumer claims it cannot meet.

These requirements would apply equally to all credit licensees, unless they are exempted from the requirement to hold PI insurance by legislation, or have alternative arrangements approved by ASIC, regardless of the kind of credit activities in which they engage.

- 102 We think that this option best meet’s our aims of protecting consumers that obtain credit services from a credit licensee, while helping licensees to understand how they can comply with their legal obligations to have in place adequate arrangements to compensate consumers.
- 103 We think that the benefits obtained by implementing Option 1 outweigh the costs associated with this option.

Implementation and review

- 104 The timeframe for commencement of the obligations in the National Credit Act will allow applicants for a credit licence a reasonable period of time to understand their new obligations in relation to PI insurance and make arrangements to obtain or update their cover—that is, applicants will have six months from 1 July 2010 to lodge an application for their credit licence, in which they must either demonstrate that they currently hold adequate PI insurance, or that they will do so by the time that they are licensed.