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Committee Secretariat
Finance and Expenditure Committee
Parliament Buildings
Wellington

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Submission on the Credit Contracts Legislation Amendment Bill

The Institute of Directors (IoD) appreciates the opportunity to comment on the Credit Contracts Legislation Amendment Bill which is intended to address issues in the credit market including strengthening requirements to lend responsibly and addressing harm to vulnerable customers. This is part of a series of finance related law reforms including reform of conduct in financial institutions that we have also submitted on.

The IoD's submission mainly focuses on director and governance related matters. Notwithstanding our comments here, the IoD may make further comments as this reform progresses.

Summary of submission

We support the intent of the Bill and the need to protect vulnerable consumers from irresponsible lending practices and problem debt. However, we are very concerned about the adverse impact that the Bill will have on responsible lenders and directors, and potential unintended consequences for vulnerable consumers. As currently drafted, the Bill places a disproportionate burden on responsible lenders, excessive penalties and damages, and an unreasonable prohibition on indemnities and insurance. The potential adverse effects of amendments in the Bill include increased compliance costs and insurance premiums, boards becoming more risk averse, and the possibility of deterring directors from serving on boards of lenders.

About the Institute of Directors

The IoD is a non-partisan voluntary membership organisation committed to driving excellence in governance. We represent a diverse membership of over 9,000 members drawn from listed issuers, large private organisations, small and medium enterprises, state sector organisations, not-for-profits and charities.

The IoD's *Code of Practice for Directors* provides guidance to directors to assist them in carrying out their duties and responsibilities with high professional standards. All IoD members sign up to the Code.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development to support good corporate governance.

Overview of key changes relevant to directors

The Bill will amend the Credit Contracts and Consumer Finance Act 2003 (the Act). The Act's purpose is to "protect the interests of consumers in connection with credit contracts, consumer leases, and buy-back transactions of land" as well as promoting confident and informed consumer participation in credit markets and providing consumer protection. A key part of the Act is that it sets out disclosure requirements for contracts.

The Bill will introduce a number of significant changes to the Act relevant to directors.

Due diligence duty
The Bill imposes a new duty on directors and senior managers of a lender to exercise due diligence to ensure that the lender complies with its duties and obligations under the Act.

They will be required to exercise the care, diligence and skill of a reasonable director or senior manager in the same circumstances, taking into account:

- the nature of the business or undertaking and
- the position of the director or senior manager and the nature of responsibilities undertaken by that person.

'Due diligence' includes taking reasonable steps to ensure that the lender:

- requires its employees and agents to follow procedures (or has implemented automated procedures) to ensure compliance with the Act and regulations
- has in place methods for systematically identifying deficiencies in the effectiveness of the procedures for compliance, and
- promptly remedies any deficiencies that are discovered.

Remedies
The Bill introduces new remedies where there is a breach of the new due diligence duty including civil pecuniary penalties (up to $200,000 for an individual and $600,000 for a company), and potential personal liability (jointly and severally with the lender) for statutory damages or compensation. There are also new civil pecuniary penalties and statutory damages in a number of other circumstances where there has been non-compliance with the Act (including in relation to the 'lender responsibility principles').

Restrictions on indemnities and insurance
Companies will also be unable to indemnify directors (or others) in relation to civil pecuniary penalties or the costs in defending proceedings in which such penalties are imposed. Directors (and others) are also prohibited from insuring against pecuniary penalties and associated costs.

Fit and proper person test
Directors and senior managers of a lender offering consumer credit contracts (or of a mobile trader) will also have to meet a 'fit and proper person' test in order for the lender to register on the Financial Service Providers Register. There are exemptions including if lenders are already licenced (eg banks and non-bank deposit takers). New regulations will provide more detail.

IoD comments

We support the intent of the Bill and need to protect vulnerable consumers from irresponsible lending practices and problem debt. It is critical that regulatory reform is proportionate and appropriate, and consistent with other regimes in New Zealand and overseas.

A key role of boards is to ensure effective compliance with regulatory environments. Boards are also ultimately accountable for what goes on in their organisations and they have a core role in leading and overseeing corporate culture and conduct.

In principal, we support the intent of the new certification and fit and proper person regime. However, more clarity is needed about the process, requirements and application. This is expected to be included in new regulations.

We are very concerned about the adverse impact that the Bill will have on responsible lenders and directors, and potential unintended consequences for vulnerable consumers (such as responsible lower cost lenders making fewer loans to such consumers and less efficient and accessible credit markets). As currently drafted, the Bill places a disproportionate burden on responsible lenders and excessive penalties and damages.

We have significant concerns with the due diligence duty that appears to merge the role of the board and management, undermining the essence of corporate governance in New Zealand. A core role of boards is to hold management to account through effective and independent oversight of performance and compliance matters. This was reinforced in the Final Report of the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019):

> "Boards cannot, and must not, involve themselves in the day-to-day management of the corporation … The task of the board is overall superintendence of the company, not its day-to-day management."

It is critical that this separation is maintained under the Bill and that the duty still permits directors and senior managers in large organisations to delegate responsibility for establishing appropriate processes and procedures while still maintaining effective oversight. There also needs to be greater certainty about what is 'due diligence' for the purposes of the Act.

The potential personal liability for directors and senior managers under the Bill is extensive and we strongly oppose it. We highlight our key concerns below and potential adverse effects.

Deterring directors from serving on boards
Directors can be exposed to significant liability in their positions and this has been increasing over time across legislative and regulatory regimes (eg in relation to health and safety). The criminalisation of cartels is another example from this year and there are other proposals to introduce director personal liability (including in tax legislation and in regulating the conduct of financial institutions). These changes have a cumulative impact on directors and organisations.

Given this, there is a real likelihood that increased personal liability could be a significant deterrent for directors and potential directors from seeking board roles in entities subject to the Act. This risk is already high for directors of such entities, when compared with directors of other entities in other sectors. Directors have the choice to contribute to New Zealand in a range of ways, and we are already aware that many favour serving on boards of private companies with a lower risk profile. In our 2018 Director Sentiment Survey, 33% of directors said that the scope of director responsibilities was more likely to deter them from taking on governance roles (at the time of survey than 12 months prior to this).

It is critical that boards are able to attract well qualified, experienced directors to help raise the standard of governance in organisations, and trust and confidence in business in New Zealand. We are very concerned that the imposition of a new due diligence duty as currently drafted and the significant addition of personal liability under the Bill for directors will limit the ability of boards to attract appropriate directors especially in larger entities subject to the Act.

Compliance and risk averse boards
Boards have a fundamental role in setting, driving and overseeing strategy. They must be continually engaged in strategic matters to ensure the long-term sustainability of their organisations. This is particularly important in today's complex and challenging operating environment for many organisations.

The impact of increased director liability adds to boards' growing regulatory burden and means they can spend disproportionally more time on compliance rather than performance. Our 2018 Director Sentiment Survey found that 71% of directors were spending more time on compliance related activities in the last 12 months. This is related in part to receiving more information on financial and non-financial risks (including on culture and conduct, digital, cybersecurity and climate issues). Lenders already have a significant regulatory workload and there is a real risk that they could be overburdened with compliance given that the amendments in the Bill are not proportionate and appropriate.

We are also very concerned that the due diligence duty and the prospect of significant penalties and damages will lead to boards becoming more risk adverse (ie not taking appropriate business risks). This could ultimately impact business success, stakeholders and consumers.

Cost burden and indemnities and insurance
The greater the regulation, the greater the increase in compliance costs for organisations, directors and consumers. The amendments in the Bill will require extensive due diligence processes, procedures, and policies and training. The cost should not be underestimated especially in large organisations.

The due diligence duty and real prospect of personal liability for directors for non-compliance with the Act will affect the cost of Directors and Officers insurance (D&O), notwithstanding that insurance is restricted in relation to pecuniary penalties. The cost of D&O insurance has already risen significantly in recent years and is prohibitive for some organisations. The Australian Law Commission noted increases of more than 200 percent in the 12 to 18 months to June 2018,[1] and we are aware that the percentage is considerably higher for some organisations. There are a number of factors that have contributed to the turbulent D&O insurance market including:

- the board's role and responsibilities have expanded in recent years
- policy-makers continue to target directors for personal liability in reforming regimes
- regulators are more active
- class actions are on the rise
- there have been substantial court awards against directors and organisations
- litigation funding is prevalent, and there are activist law firms (appearing and organising their own claims) and liquidators pursuing directors with sizeable D&O policies / personal assets.

The dramatic rise in D&O costs is very concerning and the impact of the addition of a new due diligence duty and personal liability for non-compliance with the Act could be severe.

Restrictions on indemnities and insurance
We strongly oppose the restrictions on indemnities and insurance in relation to pecuniary penalties. These restrictions are excessive and should be used sparingly by the Government. We refer to the report by the New Zealand Law Commission *R133 Pecuniary Penalties Guidance for Legislative Design*. This refers to the following comments by Justice Bathurst in his address to Australian insurance lawyers:

> "[to] my mind, excluding indemnity for civil penalty provisions would be at odds with the general acceptance that insurance is available for the civil consequences of negligent behaviour. Breaches amounting to civil penalty provisions may often be the result of honest but careless behaviour… it does not seem unreasonable to me that directors should be able protect themselves from liability for civil penalties…".

There should not be restrictions on indemnities and insurance in circumstances where there hasn't been deliberate wrongdoing or similar behaviour.

[1] Australian Law Commission Reform, Inquiry into Class Action Proceedings and Third-Party Litigation Funders (June 2018

As currently drafted, the prohibitions will also likely serve as another reason to deter well qualified, experienced directors from governing lenders.

Conclusion

We support the intent of the Bill and the need to protect vulnerable consumers from irresponsible lending practices and problem debt. However, we are very concerned about the adverse impact that the Bill will have on responsible lenders and directors, and potential unintended consequences for vulnerable consumers. As currently drafted, the Bill places a disproportionate burden on responsible lenders, excessive penalties and damages, and an unreasonable prohibition on indemnities and insurance. The potential adverse effects of amendments in the Bill include increased compliance costs and insurance premiums, boards becoming more risk averse, and the possibility of deterring directors from serving on boards of lenders.

We appreciate the opportunity to comment on behalf of our members.

Yours sincerely

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Institute of Directors