

## Carnell Inquiry: Non-monetary default

### Recommendation 2

**The committee recommends that non-monetary default clauses be abolished for loans to small business.**

**If the banks do not voluntarily make this change by 1 July 2017 then the government should act to give effect to this Recommendation.**

### Background

- 3.1 In December 2016 the Australian Small Business and Family Enterprise Ombudsman (ASBFEO or Ombudsman), Ms Kate Carnell, AO, released her report on the inquiry into small business loans (the Carnell Report).<sup>1</sup> Ms Carnell was tasked with inquiring into the adequacy of the law and practice governing financial lending to small businesses.
- 3.2 The Ombudsman found almost complete asymmetry of power in the relationship between banks and small business borrowers. She noted that this manifests itself in:
- extremely complex, one-sided contracts that yield maximum power to banks to make unilateral changes whenever they like and without the agreement of borrowers;
  - inadequate timeframes around key loan milestones that leave borrowers vulnerable;

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<sup>1</sup> Australian Small Business and Family Enterprise Ombudsman, *Inquiry into small business loans*, 12 December 2016.

- misleading and conflicting signals between bank sales staff and credit risk staff which leaves borrowers vulnerable;
  - lack of transparency and potential conflict of interest in dealings with third parties involved in impaired loan processes, such as valuers, investigative accountants and receivers; and
  - significant gaps in access to justice with nowhere to go except the court system, with borrowers having limited resources and banks having overwhelming resources.<sup>2</sup>
- 3.3 To address these issues, the Ombudsman made 15 Recommendations. The response to these Recommendations is a matter for government.
- 3.4 Prior to the hearings, the committee wrote to each of the banks asking for them to respond to the Ombudsman's Recommendations.
- 3.5 The committee was particularly interested in examining the use of non-monetary default clauses, as these have been raised in previous inquiries and are a cause of great community concern.

## Non-monetary default

- 3.6 Recommendation 3 of the Carnell Report states:

**For all loans below \$5 million, where a small business has complied with loan payment requirements and has acted lawfully, the bank must not default a loan for any reason. Any conditions must be removed where banks can unilaterally:**

- value existing security assets during the life of the loan
- invoke financial covenants or catch-all 'material adverse change' clauses.

**Implementation by 1 July 2017.**

- 3.7 The reasoning and argument supporting Recommendation 3 can be found in the Carnell Report at:  
[http://www.asbfco.gov.au/sites/default/files/Master\\_Final.pdf](http://www.asbfco.gov.au/sites/default/files/Master_Final.pdf)

## Discussion

- 3.8 The Carnell Report noted that 'non-monetary default clauses and covenants in loans contracts allow banks to trigger the default of a business loan where risk factors may have changed, even when the

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2 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 6.

borrower has continued to meet their regular payments against the loan.’<sup>3</sup>  
The Carnell Report stated:

Non-monetary default clauses and covenants in loans contracts allow banks to trigger the default of a business loan where risk factors may have changed, even when the borrower has continued to meet their regular payments against the loan.<sup>4</sup>

3.9 Non-monetary default clauses offend basic principles of fairness. If a small business has done the right thing and made all payments to their bank on time and in full, why should the bank be allowed to default that borrower? This is the question that is at the centre of the Carnell Inquiry Recommendation.

3.10 The NAB advised that it needs to be simpler for customers to understand their loan contracts, and non-monetary covenants are used to assist customers facing financial distress.<sup>5</sup> The NAB argued that without the covenants risk would increase and the price of loans would reflect this. The NAB stated:

But the main point here is that if we do not have the right to engage with the client and we do not have the right to have it as a serious covenant, it will affect two things: firstly, our ability to lend to the client and clients in aggregate – so not just that client but all small business clients; and secondly, the price for our small business client – the 5.59 [per cent] that I mentioned to Mr Kelly – is going to be higher because our risk has gone up. I understand your concern. We have to work through this because, as a banker, it would increase our risk dramatically if that was to be taken away and that is really all we are saying. We have to work through it.<sup>6</sup>

3.11 In relation to the \$5 million limit the banks argued that this threshold was too high. The Carnell Report noted that banks claim that more than 98 per cent of lending to small business customers is under \$5 million.

3.12 The ANZ stated:

We do not agree that all businesses with an individual loan below \$5 million would be small businesses. We are of the view that these reforms should apply to business groups with total business lending (sometimes referred to as total credit exposure) of up to \$3

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3 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 28.

4 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 28.

5 NAB, Correspondence, 1 March 2017.

6 Mr Andrew Thorburn, CEO, NAB, *Transcript*, 3 March 2017, p. 29.

million, not based on the size of an individual lending facility. This ensures large companies are excluded.<sup>7</sup>

3.13 Westpac also supported a \$3 million cap.<sup>8</sup> Westpac advised that ‘we are also working toward removing them from all such loans under \$3 million, and this would cover eight out of 10 small-business loans.’<sup>9</sup>

3.14 For loans less than \$1 million the ANZ advised that generally covenants are not used. Similarly, the CBA agreed that covenants should be removed at this level and Westpac was in the process of removing all non-monetary default classes at this level. The CBA stated:

Definitely \$1 million and we are now doing the work to get it to \$3 million. I think that ultimately – I do not want to pre-empt, because we have not finished the work – that is the right number. There is no magic number, but by our assessment that will cover about 99 per cent of small businesses in Australia. This is \$3 million in total facilities. Based on our experience, roughly above that number you start getting into very complex lending. I concede that that is not a bright line, but we think that is about the right number.<sup>10</sup>

3.15 During the hearing, the CBA was scrutinised on its commitment to reduce non-monetary covenants for loans up to \$3 million. The CBA advised that ‘the \$1 million we are fully agreed, but in moving from \$1 million to \$3 million there may be some carve outs as part of that.’<sup>11</sup>

3.16 Westpac explained how it uses non-monetary covenants at various levels:

The way we handle it today is: for loans under \$1 million we simply do not apply a non-monetary covenant, though it is true that they are in the contract terms. We do not apply them but they are in the contract terms. As we go from \$1 million to \$3 million, there is a bit more complexity. For those we essentially do not apply them, and they have never used a non-monetary covenant in isolation to put a customer into default. But there is a small section where we do apply non-monetary covenants. What we are doing right now – and we are doing this proactively and not waiting on the government's recommendations – is we are actually eliminating from our contracts all non-monetary covenant clauses

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7 ANZ, Correspondence, 6 March 2017.

8 Westpac, Correspondence, 7 March 2017.

9 Mr Brian Hartzler, CEO, Westpac, *Transcript*, 8 March 2017, p. 2.

10 Mr Ian Narev, CEO, CBA, *Transcript*, 7 March 2017, p. 9.

11 Mr Ian Narev, CEO, CBA, *Transcript*, 7 March 2017, p. 37.

for under \$1 million and the majority, roughly nine out of 10, for the \$3 million to one million. That is our position.<sup>12</sup>

### How often are non-monetary default clauses used?

- 3.17 Each of the banks was asked the number of times that they made use of non-monetary default clauses, of any kind, for loans of less than \$5 million and \$3 million in 2014/15 and 2015/16. The NAB advised that in 2014-15 it used non-monetary default clauses five times for loans between \$ 1m and \$3m and once for loans between \$3m and \$5m. In 2014-15 NAB used non-monetary default clauses 13 times for loans between \$1m and \$3m and once for loans between \$3m and \$5m.<sup>13</sup>
- 3.18 Westpac advised that in 2016, it undertook a review of its small business and agribusiness loans under \$3 million. This appears to indicate that non-monetary default clauses were not used at all for loans less than \$3 million. Westpac commented that this review indicates that 100 per cent of recovery action has been based on monetary default.<sup>14</sup>
- 3.19 The CBA advised that it did not keep aggregated records of the number of times it had relied upon non-monetary default clauses.<sup>15</sup> The CBA noted that 'it was exceedingly rare to instigate recovery proceedings on the basis of loan to valuation ratios or 'non-monetary' covenants alone and in the absence of missed payments.'<sup>16</sup>
- 3.20 ANZ advised that 'a total of 116 customers were identified as being in some form of ANZ enforced insolvency administration as at 31 March 2015.'<sup>17</sup> ANZ advised that 'of the 116 customers identified, 113 were in monetary default at the time of ANZ enforcement and the monetary default was relied upon to take possession of property held as security by ANZ.'<sup>18</sup> ANZ stated:

ANZ has updated its procedures to introduce more senior oversight and approval requirements before any enforcement action can be initiated and we are not aware of any instance during the ANZ financial year 2015/2016 where ANZ has used a non-monetary default to take enforcement action against a customer in its Corporate and Commercial loan portfolios.<sup>19</sup>

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12 Mr David Lindberg, Chief Executive, Westpac, *Transcript*, 8 March 2017, p. 9.

13 NAB, Answer to question in writing, NABQW13.

14 Westpac, Answer to question in writing, Wespac24QW.

15 CBA, Answer to question in writing, CBA21QW.

16 CBA, Answer to question in writing, CBA21QW.

17 ANZ, Answer to question in writing, ANZ19QW.

18 ANZ, Answer to question in writing, ANZ19QW.

19 ANZ, Answer to question in writing, ANZ19QW.

- 3.21 The ABA was highly critical of Recommendation 3 cautioning that it would force banks to raise lending rates to small business. The ABA stated:

At the moment what I perceive as the biggest threat to the levels of risk of small business lending is recommendation 3 of the Carnell report. The small business ombudsman has made it very clear publicly and privately that recommendation 3 is intended to cause banks to carry more risk when they lend to small business. It is exactly the same thing as saying that lending to small business will become more risky. The prudent thing for banks to do when lending becomes more risky is to raise the cost, reduce the availability and reduce the term of that lending.<sup>20</sup>

- 3.22 The ASBFEO was quick to reject the ABA's claims arguing that they were contradictory. Ms Carnell stated:

On the one hand the banks say they rarely use non-financial default clauses, but on the other, they say to remove them would increase risk for the banks. If you don't use them, how on earth could it possibly increase the banks' risk to get rid of the clauses?

It is disingenuous to say that removing these clauses would drive up the cost of borrowing for small businesses, given the banks already take into account a higher level of risk in their small business loan costs.

You can't have it both ways; you can't have a loan agreement that moves all the risk to the borrower, while also imposing a higher interest rate on small business customers.<sup>21</sup>

- 3.23 Ms Carnell concluded that the commitments by Westpac, CBA and the ANZ to reduce, to varying degrees, the use of non-monetary defaults up to \$3 million were positive steps. Ms Carnell stated:

Aside from NAB, these are all steps in the right direction, and we're listening to what the banks are saying on carve-outs, but fundamentally non-financial default clauses must be removed from small business contracts under \$5 million if we're to ensure all small businesses are safeguarded against what can be the devastating impacts of these clauses.<sup>22</sup>

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20 Mr Steven Münchenberg, CEO, ABA, *Transcript*, 8 March 2017.

21 ASBFEO, *Media Release*, ABA Walking Both Sides Of The Street On ASBFEO Loan Contract Reform, 9 March 2017.

22 ASBFEO, *Media Release*, ABA Walking Both Sides Of The Street On ASBFEO Loan Contract Reform, 9 March 2017.

- 3.24 The committee commends Ms Carnell on her important work on this issue. It is very difficult to support the continued use of non-monetary default clauses in small business loans. Action should be taken on this issue by no later than 1 July 2017.

Mr David Coleman

Chairman

20 April 2017