

Analysis of the bill

Overview

- 1.1 The Banking Amendment (Rural Finance Reform) Bill 2019 is a private members bill presented by Ms Rebekha Sharkie MP.

Referral of the Bill

- 1.2 On 18 Feb 2019, Ms Rebekha Sharkie MP presented a Bill for an Act to amend the *Banking Act 1959* in relation to loans to primary production businesses, and for related purposes.
- 1.3 In her second reading speech, Ms Sharkie noted that the bill was previously introduced in 2017.¹
- 1.4 On 21 February 2019 the Selection Committee referred the Banking Amendment (Rural Finance Reform) Bill 2019 to the committee for inquiry and report. On 11 April 2019 the Parliament was prorogued and the inquiry lapsed.
- 1.5 On 22 July 2019, Ms Sharkie presented the same bill to the 46th Parliament.
- 1.6 On 25 July 2019 the Selection Committee referred the Bill to the House Economics Committee for consideration.

1 Ms Rebekha Sharkie MP, Second Reading Speech, Banking Amendment (Rural Finance Reform) Bill 2019, 18 February 2019, p. 57.

- 1.7 The committee resolved at its private meeting on 11 September 2019 to conduct a roundtable public hearing on 27 November 2019.

Objective and scope of the inquiry

- 1.8 The objective of the inquiry is to investigate the adequacy of the bill in achieving its policy objectives and, where possible, identify any unintended consequences.

Purpose and overview of the Bill

- 1.9 The Bill seeks to amend the *Banking Act 1959* to impose certain obligations and requirements on authorised deposit-taking institutions in relation to loans of up to \$5 million to small primary production businesses.

- 1.10 The Explanatory Memorandum provides the following outline and rationale for the proposed changes:

Small primary production businesses are predominantly family-run and operate in perfectly competitive markets which are highly responsive to market fluctuations, weather and exchange rate movements largely outside the control of the business. Small primary production businesses ordinarily expect to make profits over a multi-year cycle rather than in each and every season; their ability to pay creditors or reduce their debt level is grounded in these profit cycles.

Operating under such variable conditions places small primary production businesses at a distinct disadvantage in managing their credit arrangements with financial institutions (Authorised Deposit-taking Institutions, 'ADIs'). Although ADIs are not responsible for the conditions facing small primary production businesses, additional protections are deemed prudent for loans to small primary production businesses.²

- 1.11 Ms Sharkie provided the following background to the Bill in her second reading speech:

I appreciate that not all institutional lenders have tightened the screws on their struggling customers, but, taken as a collective, it

is fair to say that the banks and other lending institutions have not made it any easier for their rural customers. We only have to look at the findings of the recent banking royal commission for examples. Horror stories that came out of that banking royal commission proved the farmers right – that banks were giving them and other customers a raw deal.

...

Farmers are not asking for non-commercial rates to access credit or unfair advantage; financial lenders, after all, need to remain competitive. But we are talking about addressing a policy imbalance because the pendulum has gone back too far the other way.³

1.12 The Bill proposes the following changes:

- Requires ADIs to provide a simple one-page summary ('Key Facts Sheet') of the clauses that may trigger a non-monetary default by the borrower
- Prohibits ADIs from being able to unilaterally perform a valuation of any security given in respect of the loan
- Prohibits ADIs from including catch-all material adverse change clauses in their loan documents, except where it relates to fraud or criminal activity
- Requires ADIs to provide a 30 business day notice period where it intends to exercise a power under a general restriction covenant, except where it relates to fraud or criminal activity
- Requires ADIs that conduct valuations of any security to a loan, to provide a copy of valuation instructions and final valuation reports to the borrower:
 - ⇒ ADIs must not require the borrower to meet any part of the cost the valuation
- Requires ADIs that conduct audits (i.e. investigative accounting) of the business, to provide a copy of the report to the borrower:
 - ⇒ ADIs must not require the borrower to meet any part of the cost the audit

3 Ms Rebekha Sharkie MP, *House of Representatives Hansard*, Second Reading Speech, Banking Amendment (Rural Finance Reform) Bill 2019, 18 February 2019, p. 57

- Requires ADIs to notify and request to meet with the borrower at least 6 months prior to the expiry of a term loan
- Prohibits ADIs from unilaterally varying a term or condition of the loan unless:
 - ⇒ the ADI has given the borrower at least 6 months' written notice; or
 - ⇒ the borrower has failed to comply with a term or condition of the loan (and the non-compliance is not of a minor or technical nature); or
 - ⇒ the change:
 - reduces the obligations of the borrower or extends time for payment; or
 - is a change in a rate payable under the loan that is determined by referring to a reference rate
- Requires ADIs to provide a minimum 90 business day notice period where a decision is made not to renew or extend the loan
- Requires ADIs to provide notice about borrower rights to external dispute resolution (EDR) when:
 - ⇒ a borrower receives a default notice from the ADI; or
 - ⇒ a borrower requests assistance relating to financial hardship and that request is declined; or
 - ⇒ the ADI refuses to renew or extend the borrower's loan.⁴

1.13 The EM states that 'failure to adhere to these protections will result in civil penalties for the ADI'.⁵

Definitions

1.14 The Bill provides the following definitions or references for definitions referred to in the amendments, including:

- a primary production business has the same meaning as in the *Income Tax Assessment Act 1997*. This includes most farming, fisheries and forestry activities.⁶

4 Banking Amendment (Rural Finance Reform) Bill 2019, *Explanatory Memorandum*, p. 1.

5 Banking Amendment (Rural Finance Reform) Bill 2019, *Explanatory Memorandum*, p. 1.

6 *Income Tax Assessment Act 1997*, Subsection 995-1(1).

- a primary production business small loan: 'a loan by an Authorised Deposit-taking Institution (ADI) to a primary production business that does not exceed the primary production business small loan threshold',⁷ and
- the primary production business small loan threshold: set at \$5 million, indexed each year for Consumer Price Index (CPI), using the index number from each March Quarter to determine the indexation factor for the subsequent financial year.⁸

Context

1.15 The bill has been presented to the 46th Parliament in the context of significant reforms to the Australian banking industry, including measures to implement the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission).

Evidence to the Royal Commission

- 1.16 The Royal Commission heard evidence on three important issues affecting farm loans:
- First there were cases where banks revalued land or other assets held as security, with the result that the loan-to-value ratio (LVR) changed, and the bank then relied on the deterioration in land-to-value ratio as a non-monetary default permitting the bank to call up the loan. Those who made submissions to the Commission about these matters often complained that the time given to repay the amount called was unreasonably short.
 - Second, frequent reference was made to the difficulty that farmers have in obtaining access to banking services and to appropriate support. This issue embraced several distinct elements. There was the difficulty presented by distance from the nearest branch and consequent difficulties in contacting and dealing with the manager responsible for management of the farmers' accounts (especially if the loans were being managed in an asset management unit of the bank). There was what farmers saw as the failure to recognise ordinary seasonal variations in cash flow as well as the effect of drought or other

7 Banking Amendment (Rural Finance Reform) Bill 2019, *Explanatory Memorandum*, p. 2.

8 Banking Amendment (Rural Finance Reform) Bill 2019, *Explanatory Memorandum*, p. 2.

natural disasters when deciding whether and when to act on loan defaults.

- Third, there were complaints about changes to conditions of lending in ways that were to the detriment of the borrower: whether by increasing interest rates or altering the terms of overdrafts or other facilities. And particular reference was made in this connection to the changes that followed a change in the ownership of the lender.⁹

1.17 Another issue identified related to the appointment of receivers or other external administrators to agricultural enterprises:

The central complaint made was that receivers appointed by banks did not realise fair value for the assets under management. And associated with those complaints were complaints about the ways in which receivers acted when taking possession of assets or when in possession of those assets.¹⁰

1.18 The Royal Commission also considered why small businesses should be treated differently. Commissioner Hayne noted:

Small businesses can be seen to resemble consumers in several ways. Like consumers, small businesses lack the bargaining power and resources of larger entities. They may only have limited access to legal and financial advice. The financial dealings of the business and the business owner's understanding of finance may be relatively unsophisticated. There may be substantial overlap between the finances of the small business and the personal finances of its owner, most commonly because personal assets are offered as security for a business loan. In the case of sole traders, who constitute many of Australia's small businesses, there is no legal distinction between the sole trader and the business, and the owner is personally responsible for the business's debts. And small businesses, like consumers, accept the services of banks largely on the basis of standard form contracts, which typically have strongly favoured the interests of banks.¹¹

1.19 The Royal Commission took evidence on the suitability of the definition of a small business in the Australian Banking Association (ABA) Banking

9 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, pp. 237-8.

10 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 238.

11 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 162.

Code of Practice (the Code). There was some support to have the Code govern loans to any business where the loan being applied for was less than \$5 million.¹² In contrast, the ABA proposed:

to define a small business as one that, at the time it obtained the relevant banking service met three criteria: annual turnover of less than \$10 million in the previous financial year; fewer than 100 full-time employees; and, less than \$3 million total debt to all credit providers (including amounts undrawn under existing loans, any loan being applied for and the debt of all of its related entities that are businesses).¹³

Implementing the Hayne Royal Commission reforms

1.20 Commissioner Hayne found that clearer rules for lending to farmers are needed to better protect agricultural property owners in times of financial distress, including during drought. In particular, he recommended:

- establishing a national scheme of farm debt mediation
- that valuations of agricultural land should recognise the likelihood of events such as drought and floods and the time that it may take to realise the land at a reasonable price affecting its realisable value
- that the ABA amend the Code so banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster, and
- when dealing with distressed agricultural loans, banks should: ensure that those loans are managed by experienced agricultural bankers; offer farm debt mediation as soon as a loan is classified as distressed; manage every distressed loan on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst; recognise that appointment of receivers or any other form of external administrator is a remedy of last resort; and cease charging default interest when there is no realistic prospect of recovering the amount charged.¹⁴

12 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 167.

13 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 167.

14 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report*, Vol. 1, February 2019, p. 100.

- 1.21 Commissioner Hayne recommended that the definition of a small business be expanded in the Code to apply to any business employing fewer than 100 full-time workers, where the loan applied for is less than \$5 million.¹⁵
- 1.22 Commissioner Hayne also recommended that responsible lending laws for consumers under the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) not be extended to small businesses more generally. He argued such a move would likely 'increase the cost of credit for small business and reduce the availability of credit'.¹⁶
- 1.23 In August, Treasurer Frydenberg released a Royal Commission implementation road map, which outlines how the Morrison Government will move on all recommendations requiring legislation by the end of 2020 – with one-third planned to be finalised in 2019.¹⁷
- 1.24 The banks and other financial institutions are also implementing Commissioner Hayne's recommendations. A key function of this committee's *Review of the Four Major Banks and other Financial Institutions* is to hold the banks and other entities accountable for implementing Commissioner Hayne's recommendations and making the critical changes needed to restore trust in Australia's banking sector.
- 1.25 The ABA has revised the Code in response to Commissioner Hayne's recommendations and the Australian Securities and Investments Commission (ASIC) approved the first stage of updates in June 2019.¹⁸
- 1.26 The ABA accepted all recommendations except for expanding the definition of a small business to \$5 million. The ABA has expressed its concern that:
- ...a verbatim application of the RC recommendation will have detrimental implications for the supply of appropriate credit to small business. This would defeat the original purpose and intent of the ABA Code which was to offer simplified small business loan

15 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report*, Vol. 1, February 2019, p. 22.

16 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report*, Vol. 1, February 2019, p. 96.

17 The Treasury, *Financial Services Royal Commission Implementation Roadmap*, 19 August 2019, <<https://www.treasury.gov.au/p2019-399667>>, accessed 3 December 2019.

18 ABA, *Banking Code of Practice*, 1 July 2019, <<https://www.ausbanking.org.au/wp-content/uploads/2019/06/Banking-Code-of-Practice-2019-web.pdf>>, accessed 2 December 2019; ASIC, 'ASIC approves the Banking Code of Practice', *Media release 18-223*, 31 July 2018.

contracts with fewer conditions for the vast majority of small businesses in Australia.¹⁹

1.27 The July 2019 update of the Code extends the definition of a small business to apply to any business employing fewer than 100 full-time workers, where the loan applied for is less than \$3 million.²⁰

1.28 ASIC said that its final approval is conditional on:

...an independent review of the definition of small business within 18 months of the Code's commencement. This targeted review will test the adequacy and application of the Code's small business coverage in practice, and will occur well before the Code's comprehensive review, due three years after its commencement.²¹

1.29 The new Code also includes provisions for monitoring and enforceability. All Australian Banking Association (ABA) member banks are required to subscribe to the Code as a condition of their ABA membership and the relevant protections in the Code form part of the banks' contractual relationships with their banking customers.²²

1.30 The Code will be administered and enforced by an independent monitoring body, the Banking Code Compliance Committee (BCCC). Any person will be able to report a breach of the Code to the BCCC, and consumers and small businesses with disputes about the Code protections will be able to have those disputes heard by the new Australian Financial Complaints Authority (AFCA).

1.31 The National Farmer's Federation (NFF) have noted their support of a number of recommendations made by the Hayne Royal Commission, including 1.11 'a national scheme of farm debt mediation should be enacted.' The NFF explained:

We support this recommendation and believe that such a scheme would complement the Bill. The proposal for a national farm debt mediation scheme shares the same purpose and seeks to address

19 Ms Anna Bligh, CEO, Australian Banking Association, *Letter to Dr Philip Lowe, RBA Governor, '2019 ABA Code of Practice'*, 7 March 2019, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/ReviewofSmallerBanks/Documents>, accessed 2 December 2019

20 ABA, *Banking Code of Practice*, 1 July 2019, <<https://www.ausbanking.org.au/wp-content/uploads/2019/06/Banking-Code-of-Practice-2019-web.pdf>>, accessed 2 December 2019.

21 ASIC, 'ASIC approves the Banking Code of Practice', *Media release 18-223*, 31 July 2018.

22 Australian Securities and Investments Commission (ASIC), 'ASIC approves the Banking Code of Practice', *Media release 18-223*, 31 July 2018.

similar issues as those the Bill seeks to address: to decrease the power asymmetry in the relationship between banks and small farm businesses and protect these businesses in times of hardship.²³

Key provisions of the bill

Key fact sheet

- 1.32 The bill requires ADIs to provide a simple one page summary of any clauses that may trigger a non-monetary default by the borrower. The NFF supports this provision, noting 'it will improve the transparency of loan conditions and protect small farm businesses from unwittingly triggering a non-monetary default.'²⁴

Valuations

- 1.33 The bill provides for two provisions relating to valuation of assets, firstly, it prohibits ADIs from being able to unilaterally undertake or arrange for a valuation of any security given in respect of the loan and it requires ADIs that conduct valuations of any security to a loan, to provide a copy of valuation instructions and final valuation reports to the borrower and must not require the borrower to meet any part of the cost of the valuation.
- 1.34 The ASFBEQ said clarity was needed on how the issue of valuations was treated in the bill:

...the legislation suggests that the cost of valuations should be borne by the ADI and not the small business, it would be important to make it clear that the small business still has a right to see those valuations. At the moment, the small business pays for the valuation, and we've had an ongoing argument that, because they pay, they should be able to see it. Of course, that hasn't necessarily been the case in the past. If the ADI is paying, we are concerned, if the bill doesn't state quite clearly that the small business has a right to see that valuation, that might not occur.²⁵

23 National Farmers Federation, *Submission 1*, p. 8.

24 NFF, *Submission 1*, p. 9.

25 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 3.

- 1.35 The ABA said that, under the 2019 Code, ‘banks have an obligation to give customers who have paid for a valuation a copy of that valuation’. The ABA further commented:

We haven't prohibited banks from charging for valuations, so that's an area where we differ to what's in the bill, nor do we support a provision that would say that banks are prevented from charging people for valuations. Valuations are a critical part of the business of providing credit, and sometimes, when customers ask a bank to do something, such as grant a loan, a necessary part of that process is to have a valuation undertaken. For the bank to charge for that, we believe, is reasonable.²⁶

- 1.36 The ABA was concerned that, in making the banks responsible for the costs of performing valuations, the bill would disproportionately affect smaller regional banks because ‘regulatory costs generally are a bigger burden for smaller banks than larger ADIs’.²⁷

- 1.37 The NFF noted in their submission that the Hayne Royal Commission recommended valuations be undertaken independently of the loan provider to ensure no conflicts of interest arise, but held no view as to whether the provision that prohibits ADIs from being able to unilaterally arrange or perform a valuation in this bill ‘are necessary or preferable.’²⁸

- 1.38 The NFF does support the provision to share valuation instructions and final reports with borrowers and pay for any valuations required. The NFF stated:

It would prevent a small farm business being forced to pay for the valuation of a security undertaken by a bank for that bank’s own purposes. We support a copy of the valuation instructions and final valuation report being provided to the borrower. This should help ensure that the valuation process is independent of loan processing.²⁹

Catch-all material adverse change clauses

- 1.39 The bill prohibits ADIs from including catch-all material adverse change clauses in their loan documents, except where it relates to fraud or criminal activity. The NFF noted their support for such a provision ‘we

26 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 5.

27 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 5.

28 NFF, *Submission 1*, p. 9.

29 NFF, *Submission 1*, p. 10.

consider loan terms which specify which circumstances trigger a default is fairer than a loan which does not give this certainty.’³⁰

Audits

- 1.40 The bill requires ADIs that conduct audits of the business holding a loan, to provide a copy of the report to the borrower and not require the borrower to pay for the cost of the audit. The NFF supports this provision and explained:

Even when the power to appoint an auditor is specified in the terms and conditions of a loan, the ADI has the discretion to decide if/when to appoint an auditor. This has the potential to impose significant costs on farm businesses without their consent when they are managing financial hardship.

We also support ADIs being required to provide borrowers with a copy of the report, in the interests of transparency.³¹

30-business day notice period for general restriction covenant

- 1.41 The bill requires ADIs to provide a 30-business day notice period where it intends to exercise a power under a general restriction covenant, except where it relates to fraud or criminal activity. The NFF supports this measure and goes on to state ‘if the situation is remedied with[in] the 30-business day period, the ADI should be prevented from exercising a power under this covenant.’³²

Meeting between borrower and lender six months prior to expiry of a loan term

- 1.42 The bill requires ADIs to notify and request to meet with the borrower at least six months prior to the expiry of a term loan. The NFF support this provision and notes:

It is a change to process which should not have any financial ramifications for either the ADI or the farm business It will increase the transparency and openness of the lending process (specifically, it will increase the transparency and openness

30 NFF, *Submission 1*, p. 9.

31 NFF, *Submission 1*, p. 10.

32 NFF, *Submission 1*, p. 10.

around the possibility of renewing or extending a loan) and require ADIs to engage with farm businesses in good faith.³³

Ban on unilaterally varying terms or conditions of loans

- 1.43 The bill prohibits ADIs from unilaterally varying a term or condition of the loan, except in certain circumstances. The NFF supports this provision, noting the ASIC report into unfair contract terms and small business loans which noted the imbalance in the rights of the lender versus the borrower.³⁴

Issues raised during the public hearing

- 1.44 At the hearing, the committee questioned representatives of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), the Australian Financial Complaints Authority (AFCA), the Department of Agriculture and the ABA on the bill.
- 1.45 Issues raised included questions about the need for further codification, expanding the definition of a small business and rules around who pays and has access to valuations.

Codification

- 1.46 The ASBFEO expressed support for the bill, arguing that the bill ‘very much reflects the recommendation of our inquiry into small business loans’.³⁵ The ASBFEO also noted the bill ‘reflects a lot of the changes in the new ABA code of conduct, but it codifies those and better reflects our inquiry into small business loans recommendations’.³⁶
- 1.47 The ASBFEO said ‘we believe that this Bill could be extended to include all small businesses’,³⁷ meaning any business with an annual turnover of less than \$5 million under the *Australian Small Business and Family Enterprise Ombudsman Act 2015* (ASBFEO Act).

33 NFF, *Submission 1*, p. 10.

34 NFF, *Submission 1*, p. 11.

35 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 3.

36 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 3.

37 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 5.

- 1.48 In 2016, the ASBFEO conducted an inquiry into the adequacy of the law and practices governing financial lending to small businesses and found ‘almost complete asymmetry of power in the relationship between banks and small business borrowers’, noting 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
 - 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 accountant 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.³⁸
- 1.49 The ASBEO made 15 recommendations to address what it considered to be gaps in the existing regulatory environment and required changes in industry participant practices.
- 1.50 The NFF noted this report in their submission to the Inquiry and explained: ‘these findings, which are not exclusive to farm businesses, highlight the need for stricter conditions on loans to small farm businesses. We believe that the conditions which would be mandated by the Bill, if legislated, would result in fairer lending practices. For this reason, we support the Bill.’³⁹
- 1.51 The ABA supported the recommendations of the small business loans inquiry, noting that ‘nine of the eleven Ombudsman’s recommendations for banks are consistent with the findings of the independent review of the Code of Banking Practice, and these new obligations will form part of the revised Code.’⁴⁰
- 1.52 The ABA, however, did not accept the ASBFEO's definition of a small business loan as being any loan under \$5 million. The ABA did agree to ‘expand the definition of small business beyond what is required by law so that “covenant light” contracts apply to businesses with total loans

38 Ms Kate Carnell AO, The Australian Small Business and Family Enterprise Ombudsman (ASBFEO), *Small Business Loans Inquiry*, 12 December 2016, p. 6.

39 NFF, *Submission 1*, p. 8.

40 ABA, ‘ABA responds to Carnell inquiry recommendations’, *Media release*, 28 April 2017.

under \$3 million.⁴¹ The ABA said that there was a reduction in the number of specific events that could result in enforcing these loans, and noted 'this means banks will no longer be able to call in a loan when small businesses are acting lawfully and making their payments on time, other than in exceptional circumstances.'⁴²

- 1.53 At the hearing, the ABA expressed support for the intent of the bill but argued that 'many of the issues raised are captured in the code', calling the bill 'superfluous'.⁴³
- 1.54 By contrast, the ASFBEO stated that 'a range of things in these bills are already in the code and were certainly part of our recommendations. It's just that the code still misses out on some important bits and has some what we call get-out-of-jail clauses.'⁴⁴
- 1.55 The ABA noted that the 2019 Code is mandatory for its members, and said that the Code is enforceable in a number of way:

A customer who feels that a bank has breached the code can go to AFCA, and AFCA has a broad remit to take industry codes into account in deciding what is fair in that case. In addition, in the banking code there is a provision that makes all the code provisions incorporated into contracts with customers, so the customer will also have a contractual right enforceable in courts of law.⁴⁵

- 1.56 The AFCA confirmed that the Code is 'contractually binding' for members of the ABA:

...if we are dealing with a complaint by a code member against a code member, we do look at the code very closely. Our view is, if you sign up to the code, it is contractually binding, which it is now. The resolution of that dispute will have regard both to the contractual terms but also the code.⁴⁶

- 1.57 Commissioner Hayne recommended certain provisions of financial sector codes should be 'enforceable code provisions'.⁴⁷ Legislation is currently

41 ABA, 'ABA responds to Carnell inquiry recommendations', *Media release*, 28 April 2017.

42 ABA, 'ABA responds to Carnell inquiry recommendations', *Media release*, 28 April 2017.

43 ABA, Ms Fiona Landis, Director, Government Relations, *Transcript*, 27 November 2019, p. 3.

44 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 5.

45 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 7.

46 Australian Financial Complaints Authority (AFCA), Mr Geoff Browne, Lead Ombudsman, Small Business, *Transcript*, 27 November 2019, p. 8.

47 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking,

being developed to enact the Government's commitment to implement this recommendation by June 2020.⁴⁸

- 1.58 The ABA noted that the enforceable code legislation will further enhance consumer protection provisions in the Code:

It will take at least a subset of the most important code provisions – and we don't yet know exactly the extent of that – and give them the effect of law, so that, if an ADI breaches that provision, they'll also be breaching law, and I understand that will be likely to attract a civil penalty, as well as another statutory right for customers to take a complaint against a bank.⁴⁹

Definition of a small business

- 1.59 Commissioner Hayne noted that the definition of a small business varied between government and industry entities. For example:

The *Corporations Act 2001* (Cth) (the Corporations Act) and Section 12BC of the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act) apply certain protections to small businesses, defined as those employing fewer than 20 employees, or if manufacturing businesses, fewer than 100. But Section 12BF of the ASIC Act and the Competition and Consumer Act 2010 (Cth), providing unfair contracts protections, define a small business as one with fewer than 20 employees and a contract with an upfront price of less than \$300,000, or if the contract lasts more than 12 months, a price of no more than \$1 million. The Australian Small Business and Family Enterprise Ombudsman Act 2015 (Cth) gives the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) jurisdiction over small businesses employing fewer than 100 people or taking in less than \$5 million yearly in revenue.⁵⁰

- 1.60 Commissioner Hayne also found that 'the practice within banks varies' around how definitions are applied by the banking industry, with some

Superannuation and Financial Services Industry, *Final Report*, Vol. 1, February 2019, p. 316.

48 The Treasury, *Financial Services Royal Commission Implementation Roadmap*, 19 August 2019, <<https://www.treasury.gov.au/p2019-399667>>, accessed 3 December 2019, p. 8.

49 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 7.

50 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 160.

banks adopting the 2013 ABA Code, while others applied their own definitions.⁵¹

- 1.61 The ABA said it had considered the recommendation to increase the threshold to \$5 million ‘very, very carefully’, but had decided not to increase the threshold in terms of credit exposure beyond \$3 million for small businesses under the 2019 Code.⁵² The ABA explained:

We think it's a very important issue, so much so that we engaged with the Council of Financial Regulators on it to look very carefully at the issue. We made a public statement on it in March this year, recommending that we hold off on changing that into the code and, consistent with the condition that ASIC put on the approval of the code, that we undertake, or organise, an independent review, within 18 months of the start of the code of that threshold point. It's a matter that's been looked at very carefully and has gone through the Council of Financial Regulators who recommended that we keep it at \$3 million. That is something that we would not agree with at this stage, pending the independent review that we organise.⁵³

- 1.62 The ASBFEO commented that the \$3 million threshold included in the 2019 ABA Code is an aggregate figure:

If you think about farmers, there's every chance that they will have multiple loans – for the tractor or whatever – which would make it pretty easy to edge ahead of \$3 million aggregate. We're not talking about individual loans.⁵⁴

- 1.63 The ABA responded:

In terms of the aggregate – the total credit exposure, as we call it – the code's been that way for quite a long time...So, until our

51 Commissioner Kenneth Hayne, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Vol. 1, September 2018, p. 161.

52 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 4.

53 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 4.
A copy of the ABA's letter to the Governor of the Reserve Bank of Australia, Dr Philip Lowe, outlining its reasons for not increasing the threshold to \$5 million was tabled as part of the committee's review of the smaller banking sector. See: Standing Committee on Economics, Review of the Four Major Banks and other Financial Institutions, Smaller Banks Sub-Inquiry, Documents, Ms Anna Bligh, CEO, ABA, *Letter to Dr Philip Lowe, RBA Governor, '2019 ABA Code of Practice'*, 7 March 2019, tabled 29 November 2019, <[https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/ReviewofSmallerBanks/Document s](https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/ReviewofSmallerBanks/Document%20s)>, accessed 5 December 2019.

54 Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Ms Kate Carnell, Ombudsman, *Transcript*, 27 November 2019, p. 5.

review, that's the way we think it should stay. Again, we have increased the threshold to \$3 million in the latest code.⁵⁵

- 1.64 The Council of Financial Regulators' considered this issue at its meeting in March 2019. They noted that:

...the changes to the Code already due to commence on 1 July 2019 are significant. Further, the effects of these changes and any response to them by lenders, including small to medium-sized lenders, is still to be gauged. In light of this and the tightening in credit conditions that has taken place, members supported maintaining the current borrowing threshold to define small businesses within the Code, with an independent review to be undertaken within 18 months of the Code's commencement. This would allow time for sufficient information to be gathered on the effects of the initial changes and the potential effects of the changes in the small business definition recommended by the Royal Commission. At that point it would be appropriate to consider whether to increase the limit from \$3 million to \$5 million for all banks. Members expressed a view that a limit based on total credit exposures is more appropriate than one based on loan size. Council members noted that other Royal Commission recommendations relevant to the Banking Code are expected to be implemented in the near term.⁵⁶

Conclusion

- 1.65 Commissioner Hayne observed the power imbalance between small business borrowers and lenders and recommended a range of reforms that were accepted by the Morrison Government.
- 1.66 Legislative reforms are being developed under the Treasurer's Royal Commission implementation road map including legislation to be introduced by 30 June 2020. This includes legislation to make key code provisions legally enforceable by June 2020.
- 1.67 Many of the key consumer protections extended to small primary producing businesses in this bill are already largely covered by the revised Code. Furthermore, the Code is now mandatory for all ABA members and is contractually enforceable.

55 ABA, Mr Jerome Davidson, Director, Policy, *Transcript*, 27 November 2019, p. 5.

56 Council of Financial Regulators, *Quarterly Statement*, March 2019, <<https://www.cfr.gov.au/news/2019/mr-19-01.html>>, accessed 5 December 2019.

- 1.68 While recognising that both the Australian Small Business and Family Enterprise Ombudsman and Commissioner Hayne favoured increasing the definition of a small business to cover loans up to \$5 million, the committee is concerned this may pose additional risks to lenders. The bill would expand the definition of small business beyond what is required under current laws, meaning that so-called 'covenant light' contracts apply to businesses with total loans under \$5 million.
- 1.69 ASIC has approved the 2019 Code with a loan threshold of \$3 million. There will be an independent review of the definition of small business within 18 months of the Code's commencement that will test the adequacy and application of the Code's small business coverage in practice. In addition, the Code will undergo a further comprehensive review, due three years after its commencement.⁵⁷
- 1.70 The committee notes the CFR's assessment that it is prudent to maintain the definition of a small business as it appears in the 2019 Code until the independent review is completed.
- 1.71 The bill requires ADIs that conduct valuations of any security to a loan, to provide a copy of valuation instructions and final valuation reports to the borrower. It also states that ADIs must not require the borrower to meet any part of the cost the valuation. By contrast, the 2019 Code requires the borrower to pay for the valuation.
- 1.72 Given the bill applies to a small sub-set of business loans, shifting the cost of valuations to lenders may be considered a relatively modest impost for the big banks in particular. However, if this requirement was included in the ABA Code for all small businesses, the cost implications could be substantial. This cost would be borne disproportionately by the smaller regional banks.
- 1.73 The ASBFEO supports the bill and favours extending it to cover all small businesses, meaning any business with an annual turnover of less than \$5 million under the ASBFEO Act.
- 1.74 The NFF supports the bill, as debt-finance is of vital importance to small farm businesses and 'it is important that the conditions attached to these loans are fair for both the lender and the borrower.'⁵⁸
- 1.75 While the committee supports the work of the ASBFEO in championing consumer protections for small businesses, and harmonising the

57 ASIC, 'ASIC approves the Banking Code of Practice', *Media release 18-223*, 31 July 2018.

58 NFF, *Submission 1*, p. 6.

overlapping definitions of small business across government and industry, the focus of this inquiry is into the bill under consideration.

- 1.76 The committee notes that the ASBFEO's recommendations from the small business loans inquiry were largely supported by the ABA and incorporated into the 2019 Code.
- 1.77 The committee is of the view that the review of the Code to be undertaken in 18 months from its commencement would be the appropriate time for the issue of more closely aligning the Code with the ASBFEO Act's definition of a small business.

Recommendation 1

The committee recommends the Government consider the measures raised in the Banking Amendment Rural (Finance Reform) Bill 2019 as part of its broader Royal Commission implementation road map, or in subsequent legislation.

Mr Tim Wilson

Chair

4 March 2020