17 March 2017

Senator Jane Hume
Committee Chair
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Senator Hume,

SENATE INQUIRY ON CONSUMER PROTECTION IN BANKING, INSURANCE AND FINANCIAL SERVICES

Thank you for the opportunity to make a submission to the Senate Inquiry into Consumer Protection in the Banking, Insurance and Financial Services Sector.

The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) recently completed an Inquiry into Small Business Bank Loans at the direction of the Minister for Small Business. A copy of our final report is attached as part of this submission.

We note that the terms of reference for the present Inquiry includes small businesses. We welcome the consideration of this major economic sector, which according to our research accounts for 97% of all Australian businesses by employee size, 93% by turnover and provides 44 per cent of total employment in Australia.

Although small business and individual consumers are distinct groups, they have in common an asymmetrical power relationship with large corporations in the banking, insurance and financial services sector. Our comments are based on the findings of our recent inquiry and our continuing work with the Australian Securities & Investments Commission (ASIC) and industry on behalf of small business. Our comments are focussed on the practice of banks.

Overview

The standard form contracts used by banks, particularly when used as loan agreements, demonstrate the imbalance of power weighted in favour of the banks. Unfair terms in these contracts allow the banks to minimise their risks when externalities change, often to the detriment of the small business party. Unfair contract terms legislation provides some protection in principle, but not in practice, as

it requires the small business to take the bank to court in order to obtain a determination on an unfair term.

Gaps in access to non-judicial dispute resolution processes further disadvantage affected small businesses. For banking, the existing external dispute resolution (EDR) option, the Financial Ombudsman Service (FOS), is constrained by a framework with financial caps and limited by terms of reference which have not kept pace with the changing character of small business lending.

When a small business borrows money from a bank, it usually invests the money in a specific business strategy or operation in order to grow and/or employ staff. Finance is costly and difficult to obtain and a loan agreement represents a commitment that the business uses as a foundation upon which critical decisions can be made. Small businesses depend on the certainty and security of their financial arrangements with banks. Certainty with regard to the loan amount, duration and other key aspects, are critical factors which small business rely upon to confidently pursue their growth or employment strategies. The continued commercial uncertainty arising from the banks' insistence on retaining the unilateral right to shift their own risk (at any time), without regard to the borrower's risk, means that no small business can confidently pursue their growth and employment strategies. Banks can effectively end the small business' access to finance for any reason, at any time. This has detrimental impacts not only to individual small businesses but the economy as a whole.

What small business needs is a credible commitment on the part of the lender that can serve as a solid foundation for business growth. A 'commitment' that might be changed or withdrawn at any time is not credible and cannot serve small businesses.

This submission covers the following key issues raised in our Inquiry report:

1. Unfair contract terms legislation (relates to terms of reference (a));

2. Non-monetary defaults (relates to the terms of reference (a) and (b));

3. Unreasonable notice periods (relates to the terms of reference (a) and (b));

4. Third parties procured by the bank (relates to the terms of reference (h)); and

5. Barriers to accessing justice (relates to the terms of reference (c), (d), (e) and (g).

We also provide some commentary on other reviews.

Unfair contract terms legislation

Since 12 November 2016, protections in the Australian Consumer Law against unfair contract terms apply to small business. The legislation covers contracts entered into

or renewed after the commencement date where the contract is for the supply of goods or services; at least one of the parties falls within the legislative definition of a small business, and the upfront price payable under the contract is within prescribed limits.

Ultimately, only a court can decide whether a contract term is unfair. Under the legislation, contract terms may be considered unfair if they:

- cause a significant imbalance in parties' rights and obligations;
- are not reasonably necessary to protect the advantaged party's legitimate interests; and
- would cause financial or other detriment to the other party if relied on.

Terms that are convoluted or obscure are more likely to be considered unfair. Standard form contracts in the banking, insurance and financial services industries contain many such terms, which are phrased in legal, complex and technical language, hidden in fine print or schedules and/or incorporated into the contract by reference to additional documents located online or elsewhere. Our inquiry recommended these contracts should instead be simple, short and clear with respect to each party's responsibilities, particularly for small business loan contracts.

However, transparency by itself does not constitute fairness. Standard form banking contracts contain many terms which we believe meet the criteria of being unfair. These include terms that enable one party (the bank), but not the other, to:

- avoid or limit their obligations under the contract;
- terminate the contract;
- apply penalties for breaching or terminating the contract; or
- vary the terms of the contract.

We believe the imbalance in power in the contractual relationship created by these terms is not reasonably necessary to protect the legitimate interests of the banks. Banks do have a legitimate interest in protecting themselves against commercial risk. However, they account for this risk twice: once by pricing the risk into the interest rate, and then again by allowing themselves one-sided latitude in standard form contracts. These terms go beyond managing risk, seeking instead to eliminate all risk for the lender by transferring it entirely to the small business borrower. In addition, unfair terms may persist in standard form contracts without ever being relied upon. When invoked, however, they cause extreme financial and other detriment to the other party.

In our own inquiry and subsequent work with ASIC, we have found that despite numerous inquiries and reviews – 19 in recent years, including our own – banks have done little to address the unfairness in their contracts. Since the introduction of unfair contract terms legislation, steps taken include minor changes to language (e.g.,

inserting the word 'reasonably' to qualify a right to unilateral action) and disclosing which terms are unfair. This is not the same as eliminating unfair terms.

Banks argue that the existence of such terms are not an issue because they are never relied upon. That statement is contrary to our findings, but even if true, there is no good reason why lenders should seek to preserve terms in standard contracts that they do not intend to use and which, if used, would expose them to the threat of litigation under unfair contract terms legislation.

Banks also argue that changes to standard form contracts that would bring them into compliance with legislative requirements will raise the cost of finance. In the course of our inquiry we received expert advice from former Commonwealth Bank CEO David Murray which suggested this claim is unsupported by any evidence. In any case, as already noted, if there is no intention to rely on, or use, an unfair term, then there seems no reason why removing them from standard form contracts should have an impact on costs.

Paragraph (a) of this Inquiry's terms of reference asks what failures are evident in the current laws and regulatory framework. With respect to the unfair contract terms law, a key failure is that the protection can only be accessed through the court system as only a court can determine a term to be unfair. For a small business, taking a legally sophisticated and well-resourced bank to court is not a viable option.

In addition, we consider that the prescribed limit on the value of contracts covered by the unfair contract terms legislation ($300,000 or $1 million if the contract is for more than 12 months) is too low to provide real protection with respect to small business loans. Too many such loans would be well above the $1 million limit – for example, a typical farm loan is worth around $5 million.

Non-monetary defaults

Non-monetary defaults are an example of unfair contract terms being triggered to the detriment of small business. A non-monetary default occurs when a bank defaults a borrower because of a non-monetary term or covenant in the contract. An example of a non-financial term is the loan to value ratio (LVR). This ratio is based on the value of an asset (i.e. a residential property) used as security, against the total amount of the borrowing.

A variety of triggers may prompt the bank to move even against a borrower who is meeting all payment commitments. For example, the value of the property against which the loan is secured may decline due to broader economic fluctuations, which in turn affects the LVR, so the bank demands that the borrower puts up more security or pays down the debt. The contract may contain clauses requiring a small business to keep its turnover or percentage profit at a particular level, and factors outside the business's control cause those numbers to dip temporarily. For example, the local council may decide to undertake temporary road repairs outside the business causing

a decline in customers. At any time and for a range of other external or internal reasons, the bank may decide to re-evaluate its exposure to risk.

In our inquiry, we reviewed cases of small businesses being moved into default despite meeting all their loan repayments. We learnt of cases where some small business owners were asked to repay all, or a large percentage, of the loan at short notice, as little as a single day. As we outlined earlier, for the vast majority of small business loans, the loan amount is usually invested in illiquid assets or pre-existing commitments, which support businesses operations or growth strategies. These cannot easily be recovered for sudden repayment without destroying the business.

Based on cases from our inquiry, the impact of non-monetary defaults can be devastating. The impact extends beyond the closure of previously healthy small businesses, with the obvious loss of jobs for owners and staff. It extends to the loss of trading opportunities for suppliers and other related businesses, bankruptcy, loss of the family home, separation of families, damage to physical health and long-term and/or life-threatening mental illness.

Our recommendation is that non-monetary default clauses simply should not exist. If the borrower pays the agreed amount at the agreed time and is acting lawfully, the bank should not be able to default the loan.

Unreasonable notice periods

Our inquiry found some instances where banks gave little or no notice to small business borrowers that they would not renew their loan facilities. The borrowers were then forced to agree to new, less favourable terms or otherwise to refinance completely with another lender in a very short time frame. This usually occurred under the imminent threat of foreclosure by their existing lender which severely limited their options and attractiveness to any prospective new lender.

Even though in such cases the bank may be operating within the (possibly unfair) terms of the contract, the outcome for the small business is that it is likely insolvent, or close to insolvency, from the moment the bank says it will not rollover the loan. For the small business owner this can lead to the same devastating outcomes as with non-monetary defaults, such as the loss of their family home and bankruptcy.

Third parties procured by the bank

Small business customers who are deemed to be in default often find themselves on a slippery slope with limited options to address their situation. Bank penalties, default interest rates and other costs accumulate and add to their indebtedness. This can include the fees of valuers requested by the bank to re-value an asset or investigating accountants hired by the bank at the customer's expense to assess the business operations. The matter may ultimately be handed to a bank appointed receiver. In each of these circumstances, the interests of these third parties is likely to be more closely aligned to the appointing bank. This is because the work is related to

protecting or recovering the bank's assets and not in the sustaining an existing, potentially viable business or in mitigating the personal impact on the borrower, their family and community.

Throughout our inquiry we heard that many banks, including some of the major banks, have a practice of not providing copies of valuations or investigating accountant reports to the borrowers who have paid for these reports. A small business which wishes to review the outcome or process may be told by the bank that it has no standing to request a review, or second opinion, because it is the borrower who paid the fee for the third party's services, not the bank. If the small business approaches the third party (valuer or investigative accountant) directly for the information, they may be told that it is confidential and cannot be shared with them because it was the bank that requested the report.

There is a clear incentive for these third parties to favour the interests of the appointing bank with whom they are likely seeking repeat business with, over the interests of the small business, even though the small business is technically their client. This leads to the present situation, where the business of certain third-party professionals are so closely linked to referring banks with limited, or no independent oversight of their interactions. This increases the risk, and likelihood, of unethical and unprofessional behaviour.

Barriers to accessing justice

Small businesses need to be able to access affordable, timely and binding out-of-court dispute resolution services when they experience difficulties with their bank. Existing provisions for resolving complaints in the sector do not adequately meet the distinctive needs of small business. In addition, they should be supplemented with specialised small business advocacy functions, as well as, specific and separate, small business sections included in the relevant industry codes.

Our inquiry found that some barriers which imped a small business' access to justice are the result of flaws and failures in the chain of responsibility. Staff turnover, stove-piped and separate business functions, weak or ineffective internal review processes and the lack of internal customer advocates can contribute to small business borrowers receiving conflicting messages from different parts of the bank. In one case we reviewed, staff members reviewing a complaint were the same individuals against whom the complaint was originally made.

Other problems with access to justice are the result of discontinuities or gaps in the framework. For example, the option of external dispute resolution through FOS is not available to those who have already been through a farm debt mediation process.

The lack of a quick, simple, low-cost process that can address retrospective cases of injustice leaves small business few options besides court. For small business pursing their interests through court means entering into a lengthy, and often

protracted, legal battle that they are unable to fund. Often they have little choice but to accept unfair treatment because of the extreme imbalance of power and resources between themselves and their bank.

Independent Review of the Code of Banking Practice and the Ramsay Review

We welcome the report of Philip Khoury's independent review of the Australian Bankers' Association Code of Banking Practice, endorsing our inquiry recommendation that the Code be approved by ASIC. Even if there is already adequate compliance with the Code, ASIC approval is important to build public trust and confidence. The banks' own statements at the public hearings our inquiry held said that there is no impediment to seeking ASIC's approval.

Following the release of our Inquiry report, the terms of the Ramsay Review were extended to consider potential solutions to the access to justice problem. The use of tribunals is one option, but in our view this is not the best solution because tribunal proceedings are under evolutionary pressure to become increasingly legalistic and drawn-out.

Another option mentioned in our Inquiry report was that of independent evaluations. The concept of an independent review was highlighted in the UK's Tomlinson report[1] into bank lending practices. This report indicated a need for an independent avenue for businesses which would examine the fairness of the bank's behaviour, outside of the bank's commercial decision. We believe this approach would be suitable to address issues in the Australian banking environment with the following recommendations:

- The scope of an independent evaluation should not be limited to the contract.
- It should relate to the Banking Code of Practice and unfair contract terms legislation.
- It should be truly independent, i.e., the independent reviewer must be allowed to decide for themselves what material is relevant instead of having to base a decision on material provided by the banks.
- No lawyers should be involved.
- The timeframe for decisions should be short.

Whether independent evaluation decisions should be binding or non-binding is a matter of balance. A binding decision takes away the parties' legal rights by denying them access to a court determination. On the other hand, a non-binding decision cannot be relied upon and therefore does not offer the same degree of commercial certainty and confidence. Consideration should be given to making such decisions non-binding but requiring that the decision and the reasoning, and material on which it is based, be published. This would allow this information to be available to form a basis for any subsequent court decision.

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[1] Banks' Lending Practices: Treatment of Businesses in distress accessed at http://www.tomlinsonreport.com/docs/tomlinsonReport.pdf

Conclusion

Small businesses are at a clear disadvantage in dealing with entities in the banking, insurance and financial services sector. Gaps in the legal and regulatory framework exacerbate the impact of misconduct, as do failures of culture and the chain of responsibility. To effect better protection for small business and mitigate poor practices in the banking sector, the Committee should recommend that banks undertake full and immediate implementation of our Inquiry recommendations along with the 99 recommendations in the Khoury report. In addition, a dedicated EDR scheme which accommodates small business needs must be established by the regulators and industry.

Meaningful change in this sector and justice for those small businesses already affected by past unfair treatment by the banks is an urgent priority. Action should not be dependent on further inquiry or review. What needs to be done is well known and articulated in the recommendations of the past 19 reviews. Much can be done right away through voluntary action on the part of the large corporations within the sector to improve the protection and treatment of small businesses and individual consumers.

Should you wish to discuss this submission further, please contact me or Anne Scott on or .

Yours sincerely,

Kate Carnell AO

Australian Small Business and Family Enterprise Ombudsman