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Unfair Contract Terms and Small Business Consultation Paper
Small Business, Competition and Consumer Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email to: AustralianConsumerLaw@treasury.gov.au

Attention: Shakira Jones

Dear Ms Jones,

Extending Unfair Contract Term Protections to Small Businesses

The Australian Bankers' Association (ABA) is pleased that Consumer Affairs Australia and New Zealand (CAANZ) has provided an opportunity to fully consider this proposal through its May 2014 Consultation Paper.

The ABA has written this submission on the basis that the Government having made a commitment to extending the current unfair contracts law (UCT) applying to standard form contracts with consumers, to standard form contracts with small businesses, the ABA should focus this submission on that commitment.

1. Preliminary

Of concern is that there has been no assessment of how the existing UCT regime has operated since its introduction in January 2011 despite the substantial cost to industry and particularly the banking sector in reviewing all standard form contracts including the terms and conditions of security instruments such as mortgages. For banks and other credit providers, amended real estate mortgage common terms and conditions require to be registered with State land titles registries adding a further dimension to the compliance burden.

Standard form contracts also include account terms and conditions for cheques, deposits and overdrafts.

The ABA submits that there should be a post-implementation assessment of the existing UCT regime which examines the effectiveness of the regime, the experiences of businesses and their consumer customers and a costs and benefits assessment of the operation of the UCT. This post-implementation review should be used to inform the current proposals before a decision is taken to add another layer of regulation upon businesses. For example, irrespective of whether the proposed extension of the UCT to standard form contracts with small businesses is extended to small business-to-small business contracts, a small business today may become a larger business affected by this regime.

Further, the complaints cited in Table 1 of the Consultation Paper are relatively few in number compared with the number of small business contracts entered into, and it is not clear how many, if any, of those complaints were made against banks. Accordingly, there is no evidence that banks are enforcing

contract terms on small businesses that are unfair or that banks' internal and external dispute resolution arrangements are failing to adequately deal with small business complaints.

All banking products have operational and system requirements, and standard product features that are often not easily amended for particular customers. Using standard form contracts allows banks to provide those products and services to small business customers with efficiency and certainty, helping ensure that terms and conditions reflect the banking product that will be delivered. Standard documents also help the ongoing management of products by enabling them to be updated without reference to each individual contract. Needing to negotiate more documents each time would add cost and delay to small business finance (as banks would need to consider whether more requested changes meet system and operational requirements), and make it more difficult to manage any subsequent changes.

Standard form contracts help banks obtain wholesale funding as it is easier to securitise loans on standard documentation. Making it harder in the future for banks to securitise small business loans, (currently banks do not securitise small business loans), would make it more difficult for banks to lend to small businesses.

If the Government decides to proceed in the way proposed, the range of security instruments to be reviewed will extend to commercial mortgages, company charges and a range of security instruments used in connection with the Personal Property Securities Act 2009.

A key issue, in this event, is with the definition of a "small business" which should align with the Code of Banking Practice (Code). First, because to do otherwise would result in additional compliance costs and delays where banks would need to grapple with a myriad of overlapping compliance requirements. Small businesses are ultimately likely to experience the resulting additional cost burden and delays in doing business. Secondly, the Code definition has been well thought through and targets the Code's coverage to those small business customers that are more likely to benefit from the Code. The Code definition would go some way to ensuring the proposed legislation would not unintentionally capture those more sophisticated small business customers that are better placed and more likely to read and decide on the terms of a particular commercial dealing. The definition should exclude subsidiaries in corporate groups and special purpose vehicles.

2. Summary

The ABA is opposed to the proposed legislative approach to include standard form contracts for the provision of financial products and services to small businesses for the reasons set out in this submission.

In summary, the ABA submits that:

1. The Consultation Paper calls for a case to be made out to extend the existing UCT regime to standard form contracts for the provision of financial products and services to small businesses.
2. The current level of regulation and the Code provide appropriate coverage of small business contracts for the provision of financial, products and services by banks.
3. Small business lending is more complex than consumer lending, due to the nature of the customer and their inherent risk. As a result, financial institutions require mechanisms including particular contractual terms as part of managing that risk.
4. Given the increased complexity, financial institutions require means for standardising the lending process, to keep costs down, which is in turn reflected in lending rates low enough to extend lending to the majority of small businesses. Increasing compliance will raise costs and potentially reduce lending to customers.

5. If contrary to this submission, regulation is introduced which applies to banking products ABA submits there must be a clear definition of small business aligned with existing definitions as used under the Code but excluding related entities of corporate groups and special purpose vehicles.

The degree and extent of market conduct regulation, particularly for banks, is a relevant consideration and should be taken into account when looking at whether there are comparable small business protections in other business sectors as exist in the banking and financial services sectors. This is a key issue where regulation is proposed that could unnecessarily overlap or conflict with existing regulation.

Banks are subject to strict licensing regimes under Chapter 7 of the Corporations Act with respect to financial products and services, under the Australian Securities and Investments Commission Act (ASIC Act) for consumer protection and with prudential supervision by the Australian Prudential Regulation Authority across their banking businesses.

In section 6 of this submission, the ABA provides a range of reasons why the extension of the UCT provisions to small business lending could increase the lending risk of banks and create possible detrimental outcomes for small businesses.

The ABA would consider a limited application of the proposed law that reflects an appreciation of current banking and financial services regulation and the Government's objectives for de-regulating business sectors and the avoidance of "red tape" regulation.

Paragraph 130 of the Consultation Paper states –

"A final issue is whether to extend UCT provisions to contracts for financial products and services."

By this the ABA understands that "*financial products and services"* includes those financial products and services that are defined as such in sections 12BAA and 12BAB of the Australian Securities and Investments Commission Act 2001.

The question posed in paragraph 130 predicates that "*financial products and services"* are not intended to be included in the regulatory model unless a case is made to include those products and services. This is explained by the fact that the Consultation Paper appears to contemplate extending the UCT provisions in the Competition and Consumer Act without reference to the comparable provisions under the ASIC Act.

It follows that for those who assert that financial products and services should be included in the regulatory model they should make that case rather than for the ABA to argue the "against" case.

It is expected that this would be in accordance with Office of Best Practice good regulation policy.

To quote OBPR

"*The role of the Office of Best Practice Regulation (OBPR) is to promote effective and efficient legislation and regulation by the Australian Government, the Council of Australian Governments (COAG) and associated councils. Regulation should be effective in addressing an identified problem and efficient in terms of maximising the benefits to the community, taking account of the costs. A Regulation Impact Statement (RIS) essentially codifies good policy development."*

Of course, this statement has particular relevance to the Government's current deregulation agenda and its commitment to cut $1 billion of red tape every year.

If no sustainable case is advanced, the result should be that financial products and services will not be included in the regulatory model.

To follow in this submission, the ABA seeks to assist Treasury and CAANZ in assessing a case (if any) which may be submitted by others for the inclusion of financial products and services and why the assumption underlying paragraph 130 should be maintained.

The ABA requests the further opportunity to address proponents' cases.

3. Consultation policy

Prior to its election in September 2013, the now Coalition Government in its policy statement "Our Plan: Real Solutions for All Australians" stated that it:

"*will extend unfair contract protection currently available to consumers, to small business. We will ensure that big and small businesses get a "fair-go" and do the right thing by each other in their respective marketplaces, delivering real and lasting benefits to consumers"*

This decision is seemingly at odds with the Coalition's policy position that consultation should precede announcements of new regulatory proposals.

CAANZ is a supportive, advisory body for the Ministers of its respective members. The Commonwealth Government is undertaking this consultation on behalf of CAANZ.

Further, Treasury appears to view the existing UCT legislation as too narrowly focussed, particularly in relation to the exclusion in consumer UCT legislation of price and upfront costs, and the protection of legitimate business interests. The ABA would be concerned if there were to be more regulation of standard form contracts for small businesses with their credit providers than for consumers. The varying approach to each would also lead to a significantly more onerous compliance burden.

4. Current Regulation of Financial products and services

4.1. Under Chapter 7 Corporations Act

The Act provides a comprehensive regime of regulation for these financial products and services including the licensing by ASIC of providers of financial products and services (other than of credit facilities).

Three relevant key aspects of the regime are:

4.1.1 The objects of Chapter 7

The objects include the "*confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services"* and "*fairness, honesty and professionalism by those who provide financial services" (*section760A*).*

4.1.2 To act efficiently, honestly and fairly

A financial services licensee must do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly (section 912A).

4.1.3 Dispute resolution

A financial services licensee must comply with ASIC's requirements to provide personal and small business customers with access to the licensee's internal dispute handling and to an ASIC approved independent external dispute resolution scheme.

4.1.4 Small businesses as "retail clients"

Certain small business consumers of regulated financial products and services under the Act are defined as "retail clients" with comparable protections for those individual consumers who are retail clients. Unless one of the following factors listed in section 761A(7) of the Act applies, a small business will be treated as a "retail client" when provided with a regulated financial product or service under the Act:

> *(a) the price for the provision of the financial product, or the value of the financial product to which the financial service relates, equals or exceeds the amount specified in regulations [$500,000 but variable for certain financial services] made for the purposes of this paragraph as being applicable in the circumstances (but see also subsection(10)); or*
>
> *(b) the financial product, or the financial service, is provided for use in connection with a business that is not a small business (see subsection(12));*
>
> *(c) the financial product, or the financial service, is not provided for use in connection with a business, and the person who acquires the product or service gives the provider of the product or service, before the provision of the product or service, a copy of a certificate given within the preceding 6 months by a qualified accountant (as defined in section 9) that states that the person:*
>
> *(i) has net assets of at least the amount specified in regulations [$2.5 million] made for the purposes of this subparagraph; or*
>
> *(ii) has a gross income for each of the last 2 financial years of at least the amount specified in regulations [$250,000] for the purposes of this subparagraph a year;*
>
> *(d) the person is a professional investor [see section 761GA].*

4.2. Under the Code of Banking Practice

The Code sets standards of good banking practice for banks to follow when dealing with individual and small business customers.

The provision of the Code must be reflected in the terms and conditions of a banking service provided to a small business customer. The Code then has contractual force.

The Code covers small business customers in a similar way as they are covered under Chapter 7 of the Corporations Act for those financial products and services provided to them as retail clients.

For credit facilities the Code covers small business customers which are defined to include small businesses by employment size ranges – a business of manufacturing goods with less than 100 full time employees, or in any other case, less than 20 full time employees, provided that the banking service is not provided for use in a business that does not meet either of these elements.

The Code includes the same access for a small business as for an individual customer to a bank's internal and external dispute resolution services. The Code includes a similar provision as under the Corporations Act to act fairly and reasonably towards the small business in a consistent and ethical manner taking into account the conduct of the bank and of the customer and their contract.

Banks are required to be members of an ASIC approved independent external dispute resolution (EDR) scheme. The majority of the ABA's member banks are Code subscribers and are members of the ASIC approved Financial Ombudsman Service (FOS). Incidentally, the predecessor bank scheme to FOS (Australian Banking Industry Ombudsman) was established by the banking industry in 1989.

For over a decade banks have provided internal and independent dispute resolution services for small business customers through the Code and under Chapter 7 of the Corporations Act in relation to the provision of financial services to small businesses as retail clients.

The Code provides for responsible lending to small businesses using the standard of the diligent and prudent banker and for a cooperative approach by the bank and the business in periods when the business may be experiencing financial difficulties with its credit facility. The Code (clause 28) provides for banks, with the agreement and cooperation of their small business customer which is having financial difficulties with its bank credit facilities, to try and help the business overcome those financial difficulties including by developing a repayment plan.

The Code then provides for the bank to provide a written decision with reasons to the small business whether or not the bank will provide assistance. If the bank agrees to provide assistance it will confirm the main details of the arrangements in writing.

Further, if the bank makes a variation to the terms and conditions of a credit facility of a particular small business customer which is likely to be materially adverse to the customer, the Code requires the bank to provide at least 10 business days written notice to the business of the change unless the circumstances necessitate a shorter period of notice is given to enable the bank to avoid or reduce an increase in credit risk.

5. Alternative models in the Consultation Paper

As far as the alternative options in the Consultation Paper are concerned, the ABA is:

• Supportive of small businesses continuing to rely upon current laws and even the four "light touch" elements set out in the Consultation Paper at paragraphs 91.1 – 91.4. The ABA's members have experience over a long period in developing and implementing non-legislative arrangements to deal with customers, a prime example being the Code that has covered small business customers since 2003.

• Not supportive of regulation to make standard form contracts for small businesses to be negotiated on request. Small businesses are able to negotiate and do negotiate their banking contracts with their banks on various elements of standard form contracts including price, security and term.

Across the board of small business financiers, to introduce a legislated right of negotiation on request could protract the application for finance process and delay access with additional costs.

Many of a bank's small business customers are assisted by their own professional advisers particularly when applying for financial accommodation. Their advisers are able to seek to vary the terms and conditions of a bank's standard form financial accommodation contracts on behalf of their small business clients. A bank would be responsive to a request by its small business customer to vary some of the terms of the proposed contract without the need for any legislated right for the business to negotiate. After all, the bank is seeking the business to be its customer. There are questions such as "*how would the negotiation of terms work for a bank in its broker channel?"* that would need to be addressed. "*Would brokers have a limited ability to negotiate terms?"* "*Would it be taken into account that the broker itself may be a small business?"*

This is also an issue for mobile lending channels which operate as franchises. There is already ample evidence of the poor fit between the Franchising Code (protection for franchisees across all industries) and the National Consumer Credit Code obligations on a bank as a licensee. There is there risk this initiative could potentially head down that path again.

6. Exempting Small Business Credit

The ABA's strong view is that standard form contracts for the provision of financial accommodation to small businesses by banks should be exempt from the proposed legislative intervention.

Otherwise, the scope of the legislation should carefully define and limit the grounds upon which a contractual term is able to be challenged having regard to the risks that a bank must manage in its lending decision. Further, the small businesses intended to be covered and the mechanisms by which a dispute over a claimed unfair contract term may be determined would be necessary inclusions.

6.1. Wider considerations warranting an exemption for credit contracts

The ABA's member banks are major funders and providers of financial services to Australia's small business enterprises. Overall there is a general level of satisfaction of banks' small businesses customers in their banking relationships[1]

A midpoint analysis developed by the ABA of new bank lending commitments for loans under $2 million indicates that for the entire period since the height of the GFC, the estimated number of bank loan commitments for business loans under $2 million has been higher than at any period before the GFC. For the 18 months until the end of 2011, the number of commitments for business loans under $2 million was running at a pace of over 400,000 (annual basis).

Over the most recent period (year ending March 2014), there were 363,000 business loan commitments (under $2 million). This is 46% higher than the average for the five years prior to the onset of the GFC (in late 2007).

Major concerns over recent years raised by advocates on behalf of the small business community have been about access to finance, particularly for new-start businesses and those businesses that may have a track record of less than five years in business. The ABA does not wish to overstate the risk that extending the UCT to small business standard form contracts with banks could result in a lessening of small businesses access to credit or the amount of credit available. The reason if this risk were to materialise, is the objective of a bank to protect itself from events that it is unable to influence or control that may affect the viability of the small business customer without being able to make provision in the contract with the business for these events.

This is explained in more detail below.

6.2. Financial Systems Inquiry

The Small Business Minister, the Hon Bruce Billson MP submitted to the Financial Systems Inquiry (FSI) for the FSI to examine a range of matters relating to small businesses concerning practices of financiers of which (4) below may be considered relevant in this context but which are matters for the FSI to decide:

(1) Small businesses' difficulty in accessing finance because the application process is too confusing or time-consuming resulting in a widespread practice of businesses not applying for finance (Please note the ABA has a current project with bank credit and small business experts to develop better information about undertaking banking and accessing finance for a small business).

(2) A lack of competition and innovation in small business finance and inviting the FSI to consider whether, in part, this may be due to the prudential regulatory treatment of banks and other financial institutions.

(3) A lack of lenders that support risk-taking to support the entrepreneurialship of small businesses (Please see 6.3 below).

[1] Roy Morgan April 2014 "Business banking in Australia"

(4) Lender covenants in small business financing are restrictive and can limit the ability of a business to grow and include reporting obligations by a business that can have disproportionate consequences for the businesses if these covenants are not met (Please see 6.2 and 6.3 below).

(5) An alleged propensity for all banks to force small businesses into insolvency after default rather than working with the business in an endeavour to restore its viability and inviting the inquiry to consider what regulatory factors might be barriers contributing to this (Please see 6.3 and 6.4 below).

The Interim Report of the FSI is instructive regarding these concerns. To quote from the Interim Report:

> *"Information asymmetries are the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs and can be a barrier to competition in SME lending. Limited or no access to information for potential entrants in SME lending increases the cost of establishing SME lending operations. Lenders typically will have limited knowledge about a new borrower's financial position, the financial performance of the business and the financial behaviour of the business owner. In addition, the SME sector is extremely diverse, so lenders may have limited knowledge of the conditions in, and prospects for, particular industries. Lenders are less likely to lend to newer businesses because the lender lacks familiarity with the customer's financial performance and behaviour.40 In its submission, the Australian Bankers' Association (ABA) notes:*
> *'Small business loans carry higher risk as small business incomes are more volatile, the arrangements to secure the loans vary significantly, and lenders generally are offered less information to make an assessment of risk partly due to a shorter financial history. As a result, lenders charge small businesses a premium for the higher risk.'*
> *These information asymmetries will be reflected in the price of loans. Banks may have to invest resources to acquire sufficient information to make a well-informed lending decision, which increases the cost of assessing and approving a loan application. When lenders are unable to access sufficient information to make a proper assessment, the risks associated with the loan are generally, and justifiably, perceived to be greater. This leads to higher provisioning and higher loan costs for the borrower. Some submissions raise concerns about the nature of covenants in loan contracts for SMEs. In particular, submissions suggest that some non-monetary loan covenants are unfair, and the application of some clauses, particularly non-monetary default clauses, could be more transparent. The Consumer outcomes chapter explores this issue in further detail and notes that Treasury is currently consulting on the issue. However, some of these covenants are used to deal with the difficulties in bridging the information asymmetries involved in SME lending, and therefore facilitate greater*

> *access to lending for businesses."*[2]

Further, in the Consumer outcomes section of the Interim report there are these passages:

> *"Some submissions are concerned about finance for small business, particularly about the restrictive covenants in small business loan contracts. Non-price covenants of loan contracts can make bank loans unattractive to some small businesses. Some submissions label non-price terms on small business loans 'very restrictive' and 'vague', with concerns that the way some of these terms have been applied has not been transparent. Small businesses are also concerned about the onerous nature of the loan application processes employed by some lenders. To some extent, this can reflect the quantity and quality of information that some small businesses provide to lenders."*[3]

And further:

> *"A balance needs to be struck between facilitating access to credit on equitable terms and allowing lenders to effectively manage their risk and price accordingly. Regulating business credit more intensively may reduce access to or the affordability of credit for small business."*[4]

The ABA agrees with these observations of the FSI concerning the information asymmetries which could appear to contribute to the higher cost and lower availability of credit for SMEs. Submissions expressing concern about some non-price covenants in small business finance contracts appear not to have drawn a connection between the information asymmetries identified by the FSI and the existence of these covenants. This is a critical element that must be recognised by the Government which the FSI appears to have recognised. The observations of the FSI are instructive of the caution with which the Government should proceed with this current regulatory proposal.

6.3. Different requirements for consumer and small business lending

Lending to consumers is regulated under the National Consumer Credit Protection Act 2009 (NCCP) and the Code.

The responsible lending obligations under the NCCP entail that a credit provider must assess certain things before entering into a credit contract with the consumer having been satisfied that the contract will not be unsuitable for the consumer. The obligations include that the credit provider must:

- make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract; and
- make reasonable inquiries about the consumer's financial situation; and take reasonable steps to verify the consumer's financial situation.

This is a reasonably straightforward assessment process.

On the other hand, banks effectively make an investment in their small business customers through the financing facilities they provide. In order for a bank to make a sound and prudent investment in a

[2] Interim Report p 2-62
[3] Op cit p3-82-83
[4] Op cit 3-83

business, the proprietors need to demonstrate that they understand their business, have suitable controls and strategies in place and are prepared to work to ensure the viability of their business.

For small business applicants for finance from a bank there are at least five lending principles that the bank will need to satisfy itself about in assessing the risk of financing the business:

1. The character of the business proprietor with regard to experience, expertise, management capability, business planning and related matters.
2. The capital adequacy of the business so that the business is capable of dealing with or overcoming economic and other business shocks. Often, the residence of the business proprietor is held as security for the finance which is really a proxy for the business' capital as an alternative to the proprietor selling the residence and investing the proceeds in the business.
3. The capacity of the business' current and reasonably predicted future cash flows to service the finance facility.
4. The conditions in which the business operates, for example, whether the business may only carry on business under a government licence, whether the business is subject to risk from changes in government policy or regulation, or whether it is exposed to environmental or other community risks.
5. Lastly, if the business fails is there security available for the bank to rely upon?

A bank needs to address these principles in its contract with the small business.

Lending covenants support this investment and at face value some may be seen to be unfair. However, this is not necessarily the case when it understood what these covenants are intended to achieve. The covenants are usually in standard form or adapted for inclusion in standard form contracts and can be quite extensive but also specific: limits on dividend payments, additional loans, capital expenditure, asset sales, production of reliable financial accounts and other information of the business and the possibility of additional contractual comfort being required sometimes with the need to amend the contract.

Lending covenants and, where necessary, annual reviews help banks monitor small businesses to help manage repayments and provide avenues to refinance and restructure. They also help banks monitor changes in credit risk and review facilities as required to meet prudential requirements. For example, breaches of financial covenants may give the bank a range of options including increased monitoring, more covenants, varying pricing - not just acceleration of the debt and recovery. The lending covenants benefit the small business customer by enabling it to increase its borrowing capacity (e.g. by increasing leverage or by getting a loan in the first place) in a way that helps the bank manages its credit risk.

An example of a seemingly unfair contract term that could be affected by the UCT is a term entitling a bank to change the terms of a credit facility, or terminate it with 30 days' notice, if a particular event occurs (primarily a change in the credit position of the debtor business). The clause could allow the bank to reprice the facility to take into account the higher risk of default. Under prudential rules banks have to hold more capital against higher risk customers. If this example of a clause were to be determined to be unfair, and consequently the bank did not have a right to reprice the facility (or terminate it), the likely consequence would be that the pricing across the relevant lending portfolio may have to rise to accommodate the possibility of a change in customer risk. This would lead to increased lending costs for small businesses on a portfolio basis.

History has proven that small business enterprises have a higher probability of default compared with retail home loan customers. A higher risk margin is therefore required on business loans to cover this increased risk. This is often the case with immature businesses operating with less than five years' experience.

Small business customers also tend to result in a higher loss once default has occurred. A factor driving higher losses is the wider range of security options available for small business finance such as security over equipment, receivables, inventory and assets such as farming properties and other assets that can be vulnerable to rapid deterioration in value under variable economic conditions.

The point is that robust provisions in small business finance contracts are necessary and legitimate in order to ensure a bank meets its prudential obligations and its obligations to its shareholders.

6.4. Problem solving and managing credit risk

6.5. The Code

As mentioned above, the Code makes provision for a bank with the agreement and cooperation of its small business customer to try and help the business overcome its financial difficulties with its bank credit facilities, including by developing a repayment plan. The bank will advise the customer in writing with reasons whether it is able to assist the small business and, if so, the main details of the assistance.

6.6. Dispute resolution

Membership of FOS means that any financial institution member of FOS that provides banking or other financial services to small businesses will be subject to FOS' small business dispute resolution jurisdiction if a dispute arises with the small, business customer.

Banks have internal dispute resolution facilities in place to handle customer disputes including with small business customers. If the dispute cannot be resolved expeditiously, the business is able to lodge the dispute with FOS.

This means that FOS is able to entertain disputes from small businesses about their contractual relationships or other relationships with their bank. Unlike the court, FOS' service is free to the business and FOS's decisions can be made on the basis of the banking services contract with the business, good banking practice and fairness in all the circumstances.

At present, looking at the FOS' most recent Annual Review 2013, under Applicant type, the vast majority (94%) of the disputes lodged in 2012-2013 came from individuals (consumers) while almost 6% only were from small businesses. Disputes lodged jointly by an individual and a small business accounted for less than 1% of the total.

If the proposal to legislate for unfair terms in standard form contracts with small businesses proceeds, it can be expected that these types of issues will be included as "make weight" unmeritorious claims in broader disputes made to FOS, more so because of the circumstances described below in sub-paragraph 6.6.1 below.

6.6.1 Ability for a dispute to prevent recovery action by a bank

The FOS Terms of Reference provide that a dispute lodged by a small business under a finance contract where the contract provides for a credit facility of up to $2m will prevent a bank from continuing existing legal proceedings relating to debt recovery against a small business until after the dispute has been resolved. The bank cannot commence legal proceedings for recovery after a dispute has been lodged with FOS.

In either case, if the bank is seeking to exercise any rights it might have to freeze or otherwise preserve assets the subject of the dispute, it must first obtain the consent of FOS and only on such terms as FOS may decide.

It can take up to many months and in some cases over a year to resolve a small business dispute.

ABA member experiences with the operation of this FOS rule, before the monetary limit of $2m was introduced in January 2014, were that in many cases the financial position of the disputing small business had seriously deteriorated so much as to a point of complete failure or significantly reduced prospects for refinancing or recovery.

Providing small businesses with a new, free, non-curial reason to dispute a contractual term on the ground of the UCT model and stay a recovery process following its default under the bank's finance contract, will inevitable increase the potential for the loss, given default, risk for the bank.

6.7. Prudential supervision

The Basel Committee on Banking Supervision published its Principles for the Management of Credit Risk in September 2000 (No. 75)[5] which apply to banks (see www.bis.org/bcbs/publ.htm) The Principles contemplate that for a bank to properly and adequately manage credit risk it must have the ability to amend, renew and re-finance existing credits, administer credit risk bearing portfolios, take account of future changes in economic conditions, assess credit risk exposures under stressful conditions and respond and have in place a system for early remedial action on deteriorating credits, managing problem credits and similar workout situations. In order to meet these prudential principles banks must have the ability to vary contracts unilaterally. Standard form contracts must have relevant non-negotiable terms and conditions for these purposes.

Principle 16 states: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

The ABA believes these principles remain extant.

6.8. Judicial reluctance to interfere with commercial contracts

Courts have been reluctant to intervene in a financier's judgments on the terms and conditions for their standardised financing contracts and for good reason. In Citibank Savings Bank Ltd v. Vago, an unreported decision of Cole J in the Supreme Court of NSW (1 May 1992) His Honour observed that the court should judge the foreseeability of future events and the need to make provision in financing contracts for those events against the historical background of cyclically collapsing values. The court should be reluctant to assume that the commercial judgment of experienced financiers is unreasonably in error in requiring a particular level of security for a loan.

This principle is equally applicable in the formation generally of contractual terms in financial services contract with small business. It is not and should not be the role of regulators or the courts to replace the experience and commercial judgment of a banker in determining appropriate contractual terms with the view of the regulator or the court, for example in deciding whether a particular term is necessary protect the legitimate interests of the bank.

The observations of the FSI in its Interim Report cited above are consistent with this principle.

6.9. Costs of reviewing existing standard form contracts

When the ACL introduced its regime for regulating unfair contract terms in consumer standard form contracts, it was acknowledged by the Government that there would be a substantial cost to industry to review all of their standard form contracts to ensure they were compliant.

For banks this was an extensive and costly exercise. Banks have a broad range of standard form contracts which include security documentation such as, on the credit side, commercial mortgages,

[5] http://www.bis.org/publ/bcbs75.pdf

company charges and a wide range of other business related contracts such as performance guarantees, letters of credit and personal guarantees.

Further, there is a wide range of non-credit standard form contracts, for example, covering business non-cash payment facilities, deposit, cheque and investment products, foreign exchange transactions and hedging and other financial risk management facilities.

7. Consultation Paper Attachment A: Options for legislative amendment

7.1. A: Defining 'small business' for the purposes of the unfair contract term provisions

The ABA submits with respect to the Options A.1 – A.4 in Attachment A of the Consultation Paper as follows subject to its preferred option at 6.3 below:

- Option A.1 is opposed because businesses other than publicly listed businesses can include a class of businesses that are not small businesses which are sophisticated, highly resourced with access to advisory and other services.
- Option A.2, superficially, could be considered workable if it is combined with an annual turnover test (A.3 $2m), with both tests applied at the time the standard form contract is entered into with the small business and apply as determined at that time throughout the term of the contract. However, an annual turnover test may require banks to collect additional information in some circumstances; for example, banks will not generally obtain annual turnover information from the customer if the bank is not providing a credit product. Further, there would be significant cost for banks to collect and maintain up to date customer turnover and staff numbers. Provided standard form credit facilities contracts with small businesses are exempt, the transaction threshold for financial services could be set according to related regulatory provisions, such as under Chapter 7 of the Corporations Act with the product value test of $500,000 which determines whether a client is taken to be provided with a financial product or service as a "retail client. However, the ABA concludes this is not a preferred model.
- Option A.3, provisionally, is considered workable with an annual turnover test of $2m if it is combined with the transaction threshold test (A.2), with both tests applied at the time the standard form contract is entered into with the small business and apply as determined at that time throughout the term of the contract. The ABA repeats its comments on Option A.2.
- Option A.4 is opposed because the employee numbers test in the ABS definition does not exclude businesses that are not small businesses which are very sophisticated businesses that are able to operate with minimal employees. These would include subsidiaries of larger businesses and special purpose vehicles. Further, it is unworkable as it is difficult to confirm who an employee is and how many there are.

7.2. Another option

One option (although not considered by the ABA to be workable for a bank to adopt) which has not been considered in the Consultation Paper for scoping the reach of the legislation but could possibly remove some of the uncertainties is an opt-in where a business could have the benefit of protection if it seeks it upfront. If the small business opts to self-identify and requests "small business treatment" (where the other business may be able to rebut the claim to meet the criteria prior to entering the contract) it would make it easier to ensure that the protection is appropriately targeted for both parties and that the pricing of the compliance cost would not extend unnecessarily.

There would be complications for a bank in operating under this option given the possibility that alternative standard form contractual terms may be necessary depending on the circumstances.

In order to realistically compare the feasibility of this option with other options, the Consultation Paper in Attachment A paragraph 26 suggests further research should be undertaken about an appropriate monetary threshold test for different business sectors. If the preferred ABA option below is not accepted, the ABA considers this research should be undertaken and further consultation then undertaken with stakeholders including the ABA.

7.3. ABA's preferred option

Subject to the ABA's primary submission for the exclusion of banking products and services from any UCT-style regime, in order to minimise implementation costs for banks, the definition of a "small business: should follow on the lines of the Code definition but modified to include the "retail client" test in Ch 7of the Corporations Act to cover small business credit facilities. As mentioned earlier in this submission, it would be important for subsidiaries in corporate groups and special purpose vehicles to be carved out.

However, it is important to restate that small businesses would not gain any additional substantive benefit in a practical sense over and above what is now available under the Code and current legislation. Any minimal benefit would be outweighed by the costs of implementation and increased risk in lending, both of which have the potential to result in potential detrimental impacts on access to and the cost of finance.

The ABA offers to work with Treasury on an appropriate draft for this definition.

7.4. B: Capturing under the extension a contract where a small business either acquires or supplies goods or services?

The ABA submits that as the proposed legislated model is to regulate business to small business standard form contracts, it would be inconsistent with the objective of small business protection if a small business supplier was able to employ its standard form contract to provide products or services to another small business where the contract contains unfair terms.

This also applies in the case of C below in 7.5.

One aspect that may need to be considered is whether in acquiring products or services a small business requires its own standard form procurement contract to be used. In this case, the procurement from another small business would require the contract to be regulated under unfair terms regulation.

7.5. C: Should the extension allow small business to small business contracts to be captured

As mentioned above, to not include these contracts would the undermine regulatory intent to protect small business from unfair contract terms just as the ACL is intended to benefit consumers under business to consumer standard from contracts including small business to consumer contracts.

7.6. Should the extension capture financial services and products

The ABA repeats its earlier submission that those who argue the case for capturing financial services and products including credit facilities under standard form contracts have the onus of establishing the case.

The ABA has advanced its reasons why capturing banks' standard form contracts with small business customers (particularly credit contracts) should be avoided in the absence of an opportunity for the ABA to consider any "for" cases submitted.

The ABA requests that it has an opportunity to address those submissions in this consultation process.

8. Conclusion

In conclusion the ABA submits that in a climate of Government seeking to reduce "red tape" on businesses, the option of a limited, targeted regulatory model for this policy initiative should be pursued.

Anecdotally, the ABA hears from proponents for this initiative that banks are not the target of this regulation. The ABA and its members do not wish to stand in the way of appropriately targeted protection for small businesses in our seeking an exemption for banks' standard form contracts for financial products and services, including credit contracts.

Yours sincerely

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