Min-it Software

Financiers Association of Australia

Joint Submission –

TREASURY Consultation –
Extending Unfair Contract Term Protections to Small Businesses

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Background Information

This submission is made on behalf of the Financiers Association of Australia ("FAA") and Min- it Software clients.

The Financiers Association of Australia ("FAA") and Min-it Software ("Min-it") welcomes the opportunity to submit this submission on Treasury's consultation on extending unfair contract terms to small businesses.

The FAA, having been established since the 1930's, is an organisation for individuals and companies involved in the fields of finance and credit provision. The FAA's members are either non-ADI credit providers, providing loans up to $5,000 over terms of up to 2 years, mortgage financiers or business financiers.

Aside from the software produced in-house, specifically by or for franchised organisations, Min-it Software is a leading loan management software supplier to the micro-lending sector of the Australian market. Additionally, it has a number of clients providing motor vehicle finance as well business loans and consumer leases.

Whilst some of Min-it's clients are members of either the FAA or the National Financial Services Federation ("NFSF"), the vast majority are affiliated with no industry association.

We take this opportunity also of thanking Treasury for the extension of time granted to make this submission.

Introduction

Just over 4 years ago, in July 2010, the Consumer Credit Unit, Retail Investor Division of Treasury issued a Green Paper[1] calling for comment on proposals to afford the same degree of protection to small businesses as consumers.

Essentially, this proposal by the current Minister for Small Business does exactly the same as the earlier proposal from the previous Government.

In our submission to the Green Paper, we questioned whether or not this was to be another case of *kanseifukyo*[2]. As we stated, "[a]ccording to Takehiro Sato, the chief Japanese economist at Morgan Stanley in Tokyo (in 2007), "*kanseifukyo*" means 'a recession caused by the government due to over-regulation' and the well intentioned regulatory interventions that Japan introduced led to it being "yet another example of unintended economic consequences". We see no reason why it should not be the same here."

Since we made that comment, we have not changed our minds and at the Treasury Credit Industry Working Group meetings that followed, all industry participants, except for the consumer advocates, were unanimous in not wanting to see such a proposal implemented.

[1] The Treasury, July 2010. "National Credit Reform: Enhancing confidence and fairness in Australia's credit law". Available online http://archive.treasury.gov.au/documents/1852/PDF/National_Credit_Reform_Green_Paper.pdf viewed 29 July 2014.
[2] Clenfield, J. 2007. "Kanseifukyo Threatens Koizumi Prosperity as Japan ReRegulates", Bloomberg,com, 26 November 2007. Available online http://www.bloomberg.com/apps/news?pid=20670001&refer=home&... viewed 27/11/2007.

The Current Consultation

To quote from the Minister's Media Release[3], the Hon Bruce Billson MP states:

> "We know small businesses often lack the bargaining power, time and resources to closely review terms in standard form contracts offered by larger businesses and that any unfair term in these 'take it or leave it' contracts may be detrimental to the smaller party. Getting the balance right between protecting small business against unfair contract terms, while at the same time not imposing unnecessary burdens on business, is an important consideration in the current consultation. Larger businesses have nothing to fear from the extension of consumer protections to small business if they are engaging in fair commercial practices."

For credit providers, should this provision come into effect, whilst there may be a positive impact, these are outweighed by the negative impacts. For our members and clients, the vast majority of whom fall under any of the small business definitions, examples of positive impacts could be:

- the ability to argue that their Telco contracts are unfair as they generally impose greater cost burdens on a small business than those that apply to consumers generally;
- the ability to challenge mainstream lenders that have shut them out of funding avenues as they are seen as competition (many can't); and
- for those lenders that are still able to secure funding from their bank, they could argue that the interest rate the banks charge or their commercial account fees are too high when compared to other consumer loans.

[3] Billson, B, MP. Media Release, 13 June 2014. "State and Territory Ministers support unfair contract extension" Available online http://www.brucebillson.com.au/2014/06/13/state-and-territory-ministers-support-unfair-contract-extension/ viewed 15 June 2014.

Whilst this proposal is well-intentioned and many other small businesses would equally see areas of merit in implementing it, it contains a number of possibly unintended consequences that may not be readily apparent.

We must remind Treasury that given:

- the huge failure rate of new businesses;
- the crippling regulatory criteria that may be used to determine just who should and who should not be covered by whatever protection that would be introduced;
- the requirement to show the ability to consistently pay the repayments, coupled with the perceived lack of ability for lenders to recover their losses in Court in return for their risk taking due to the ability for a borrower to take a dispute to External Dispute Resolution ("EDR") and claim unfairness;

credit providers have little appetite for such proposals, however well-meaning, if legislative or regulatory requirements are such that they cannot do so in an economic manner that also provides consistency.

Business Failure Rates

According to a Herald Sun article[4] published on 7 August 2013, citing Australian Bureau of Statistics ("ABS") data, an average of 44 small businesses failed each day due to "skyrocketing electricity prices, escalating labour costs and red tape." Between June 2011 and June 2012, the article states the number of small businesses, "defined as earning less than $100,000, plunged from 978,700 in June 2011 to 962,649".

[4] Cornish, L and Landy, S., August 7 2014. "Average of 44 small businesses closing their doors each day, according to Australian Bureau of Statistics", Herald-Sun. Available online http://www.heraldsun.com.au/news/victoria/average-of-44-small-businesses-closing-their-doors-each-day-according-to-australian-bureau-of-statistics-data/story-fni0fit3-1226692393716?nk=7880cc84a70c7f63f62b18783560001c viewed 23 August 2013.

Another article[5] cites ABS data that showed "42 percent of small businesses failed between 2003 to 2007 and more than 30 percent since 2008. Furthermore, 1,095 Australian businesses were placed into insolvency or external administration in March 2009 and a whopping 1,123 businesses in February 2012, as reported by ASIC."

The article states these reasons as to why almost 60% of small businesses fail in the first three years:

1. Lack of experience
2. Poor location
3. Poor financial control
4. Ineffective strategic management
5. Insufficient cash flow planning

and we would add a seventh reason, inadequate capital.
Inadequate capital can be overcome by finance but in light of the long-established rate of failure figures, which are not unique to Australia, no lender is going to provide capital without security. For most small business owners, there is one main asset – the family home.

Regulatory nightmare - Lack of uniform definitions

For example, under s.45A of the Corporations Act 2001, ASIC deems many businesses to be 'small proprietary companies', if they meet two out of these three characteristics (and all of the following apply for a given financial year):

- an annual revenue of less than $25 million;
- fewer than 50 employees at the end of the financial year, and

[5] Alex, C., 02 May 2013. "Why small businesses fail in Australia", Dynamic Business. Available online http://www.dynamicbusiness.com.au/small-business-resources/managing/why-small-businesses-fail-in-australia-02052013.html viewed 28 July 2014

- consolidated gross assets of less than $12.5 million at the end of the financial year.

but under s.761G (12) of the same Act, a small business is one that employs less than:

- if the business is or includes the manufacture of goods, 100 people; or
- otherwise 20 people.

These are not the only definitions. The Australian Taxation Office ("ATO") defines a small business as one that has annual revenue turnover (excluding GST) of less than $2 million whilst under s. 23 of the Fair Work Act 2009, Fair Work Australia defines a small business employer as one that has less than 15 employees. Other regulators informally adopt the definition of 'small business' used by the ABS, which is a business employing less than 20 people. The ABS notes categories of small businesses include:

- non-employing businesses - sole proprietorships and partnerships without employees;
- micro businesses - businesses employing less than 5 people, including non-employing businesses;
- other small businesses - businesses employing 5 or more people, but less than 20 people;

and those small businesses tend to have the following management or organisational characteristics:

- independent ownership and operations;
- close control by owners/managers who also contribute most, if not all the operating capital; and

- principal decision-making by the owners/managers.

The important thing to note here is that a business entity may or may not qualify under one of the definitions in any financial year, so from a purely regulatory perspective, if an entity (company, partnership or sole trader) takes out a loan and then grows and so no longer qualifies, should the small business definition apply now? How does the credit provider establish if the definition applies at the time of application or claim? This could become very intrusive.

For example, does the credit provider have to obtain a statutory declaration from their accountant? Equally, the reverse could occur. Why should the credit provider be subject to 'consumer' rules for a borrower that didn't apply at the start of the contract? What if a company subsequently restructures and makes all its employees contractors or it becomes a holding company with few employees for subsidiary companies employing large numbers? Which definition applies? The Corporations Act, Fair Work Act or the ABS's? The fact that there is a lack of uniformity as what constitutes a 'small business" is unfair in itself as an entity can be a small business under one definition but not another.

Regulatory nightmare - Credit provision

Under the National Consumer Credit Act 2009 (Cth) ("NCCP"), all lenders are required to perform an assessment to ensure they meet their responsible lending requirements and loan suitability obligations. If the applicant(s) cannot meet these without risk of hardship or losing their homes, then the application must be declined.

Consequently, if this proposal were implemented and unfair contract terms were extended to small businesses, all lenders would have to perform the same

checks for them too. Many already do as we know of no lender that lends money without being fairly sure it can get a return or it can recover any loss by way of selling the collateral. For most business loan lenders, the collateral tends to be real estate and that means the family home. If the family home is to be put up as security, however, most small businesses would not qualify for any funding because of the NCCP requirements.

Entrepreneurship would die instantly as new start ups have no trading history and so they could not satisfy any responsible lending requirement because the applicant is required to prove they can meet the repayments and that the loan is suitable. With the risk of losing the family home, the presumption must be to decline the application. Should the credit provider approve the loan, they face criminal prosecution by ASIC if they cannot prove the loan was suitable and that responsible lending requirements have been met.

Whilst an exemption could be created, would such an exemption be seen as unfair in itself?

External Dispute Resolution

Since the NCCP Act came into existence, the number of matters going before the Courts has dropped to an almost non-existent level. This is because all Australia Credit Licencees ("ACL holders") that engage in consumer lending must belong to one of the two ASIC-approved EDR providers, Credit Ombudsman Service Ltd ("COSL") and Financial Ombudsman Service Ltd ("FOSL") and consumers have the ability to take disputes to these EDR providers for free as their services are paid for by the ACL holders. ASIC requires all ACL applicants to belong to one of these two organisations before it will accept any ACL application.

Under the terms of ‘membership’, ACL holders must submit to the EDR providers’ rules and both have given themselves the ability to review almost any part of their business. So, whilst many have been compelled to join one of these two EDR providers because of their consumer loans, their loans with businesses are able to be equally reviewed by the EDR providers.

We know of many instances where disputes have been dragged on for months (in at least two known cases, over a year), court action stopped hours before a hearing and where assets have been sold under the nose of the credit provider because both providers have a rule that once the matter is in dispute, the credit provider cannot take any further enforcement action otherwise they likely to be referred to ASIC for breaching the EDR provider’s rules. Whilst they claim to be improving, a number of members still allege they take far too long to deal with alleged disputes.

To avoid this, the FAA and Min-it have long recommended that credit providers engaging in business finance set up separate entities as they are currently not required to be licenced. It should be noted Treasury has previously floated an idea to require all credit providers hold an ACL or that business lenders be registered and subject to EDR but this was rejected by the Industry Groups.

As the vast majority of business lenders are ACL holders, if the matter were to go to EDR, the EDR providers could easily rule. For example:

- that flat interest rates or capitalised interest loans are unfair; and
- allow claims for hardship when the companies are trading insolvent. We know of a number of instances where the latter has already occurred;

but if this proposal were implemented, the EDR provider would also have to verify the borrower's "small business" qualification. That will add further to the cost of EDR and is likely to further increase borrowing costs.

It should be pointed out here that a review of the NCCP Act is scheduled for next year and one of the main industry contentions will be the way the EDR providers are allowed to operate. The EDR providers have increase costs despite increasing membership and unlike the Courts, 'members' have limited rights of appeal. 'Members' see no financial accounts and despite being "not for profit' organisations, no ability to impart membership concerns at Board level. In many respects, they have replaced the Courts and make decisions that only a Court can make yet the member cannot challenge their decisions because of the way the rules have been made. Some feel so strongly about this we know of a number of current credit providers who have indicated they will consider exiting the industry unless changes are made.

As we stated in a submission to ASIC dated 11 September 2009 on 'Dispute Resolution requirements for consumer credit and margin lendin*g', "*although the Courts are separate from Parliament, given the way in which ASIC can regulate the EDR scheme providers, there is the real ability to direct them to dispense forms of social justice" and this is what industry perceives to be the case. Should the unfair contract terms be applied to small businesses, we see the EDR providers' oversight becoming larger when the finance industry wants their abilities curtailed.

Furthermore, with the extension of time granted to March 2015 for businesses to join one of these two EDR providers so they can deal with any Privacy issues as a result of the introduction of the Privacy Amendment (Enhancing Privacy

Protection) Act 2012, many businesses that are not ACL holders but who will be deemed to be credit providers so may become unwittingly subject to their rules for matters far wider than just privacy.

We assert matters of unfairness should go before a Court and not EDR.

Recommendation

Whilst the Australian State and Territory Ministers might have thrown their support behind an extension of unfair contract term protections to small businesses, it may be appropriate to exempt some industries or classes of contracts from complying, such as occurs with insurance contracts now.

We suggest this matter should not be a knee-jerk reaction but be given very careful consideration before any implementation. It may actually deter some suppliers, whether they are suppliers of goods, services or credit, from providing them to small businesses. If that occurs, given that Treasury's own figures show that small businesses account for "almost 46 per cent of total private sector industry employment in June 2011 (4.8 million persons out of a total of 10.5 million persons)[6]", it is likely to have far wider unintended consequences.

[6] Department of Industry, Innovation, Science, Research and Tertiary Education, December 2012. "Australian Small Business: Key Statistics and Analysis", p.23. Available online http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2012/Australian%20Small%20Business%20-%20Key%20Statistics%20and%20Analysis/downloads/PDF/AustralianSmallBusinessKeyStatisticsAndAnalysis.ashx viewed 29 July 2014/