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14 May 2015

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Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015

The Australian Bankers' Association (ABA) is pleased to have the opportunity to provide its views to Treasury on this Exposure Draft Bill. This response is formed of three main parts, reflecting ABA's comments which cover:

1. Areas where the draft legislation is ambiguous and the ABA seeks clarification in the Bill;
2, Proposed exclusion of financial services contracts from the Bill; and
3. Transitional arrangements and commencement date.

The ABA acknowledges the current situation where the Government has made a clear election commitment to extend the current unfair contract terms legislation in the ASIC Act and in the Australian Consumer Law to small businesses. Our response therefore focuses on those areas where ABA is seeking additional guidance from Treasury, or wishes to draw attention to technical implementation difficulties caused by the proposed drafting.

As Treasury is aware from the previous consultation process and specific discussions with the ABA and member banks, the ABA does not agree that the broad scope of the draft Bill to include standard form contracts for the provision of financial services and credit facilities is necessary, warranted or desirable.

The ABA has provided material to Treasury indicating the absence of a clear basis on which financial services, including small business credit contracts, are necessary or warranted for inclusion in the proposed legislation.

It appears that small businesses intended to be covered by the legislation are to be treated as comparable with consumers. Therefore a comprehensive legislative scheme has been considered by the Government to be necessary by extending the current provisions of the Australian Securities and

Investments Commission Act 2001 (ASIC Act) regarding unfair contract terms and consumers to small business consumers.

Whether the protections offered to small businesses as consumers under the Bill will prove necessary and desirable for them is unclear. As the predominant financiers to small businesses and as prudentially supervised financial institutions, banks must ensure that their risks associated with a business customer's potential lack of financial viability are covered in the assessment of the business applicant and then contractually.

Exposing a bank's contractual terms to avoidance under a consumer protection model by which risk under the contract is, in effect, reassigned to the bank to protect itself from its customer's business failing, inevitably must result in some impacts on a bank's future lending decisions, particularly with respect to the risk in providing access to unsecured credit facilities.

1. Clarity on the proposed Bill

1.1. Small business definition

The ABA acknowledges Treasury's intention to limit the scope of the Bill to only small businesses which are more likened to consumers. However, we are concerned that the proposed definition goes beyond this intention.

As recently submitted to Treasury, although the Bill introduces a definition of a small business for the purpose of defining the scope of the businesses to be covered under the Bill, a business employing fewer than 20 employees could still be a substantial business and not a small business according to the ordinary understanding of what constitutes a business as "small". Despite the upfront price thresholds, a small business contract could include a contract with a significantly large business and even a listed company.

The Bill applies the notion of the upfront price as used in the existing consumer unfair contract provisions for a second and different purpose compared with its application under the existing law; that is to define what is and what is not a small business contract.

However, in the case of a non-credit financial product (or service) the consideration or upfront price is not the value of the product as is the case with a credit contract. Rather, the consideration is the fee or charge made by the bank for providing the product or service to the business.

Therefore, despite a small business being defined as a business employing fewer than 20 employees, a small business contract for the provision of a non-credit financial service would include a far greater range of businesses limited only by their number of employees and extend to include complex, high value wholesale and other financial services which would be clearly outside the intended limited scope of this proposed legislation.

The ABA submits that a further defining factor is necessary to limit the scope of the small businesses intended to be covered by the Bill which we would like to discuss with Treasury.

Further, the current definition would include special purpose vehicles and subsidiaries of larger groups which are not small businesses, which the ABA believes would be an unintended consequence, and not in line with the original policy intent of these proposals.

A material concern for banks employing a franchising model to provide and extend the reach of their banking services to the wider community, for example through the means of a Community Bank structure (or for their internal resourcing), many of a bank's franchisees may fall under the definition of a 'small business', if not at the outset, then at the point of renewal of their franchise agreements.

The franchising sector is already subject to a mandatory industry code which was recently reviewed and amended. Franchisees have been afforded protections under the amended Franchising Code of Conduct including a new good faith obligation and the provision for compensation for goodwill.

The Bill should exclude such arrangements or, at a minimum, ensure that the regulation making power in clause 12BL (2) of the Bill is able to recognise these arrangements which clearly satisfy a public interest test.

The current definition also causes implementation challenges for banks, and may mean, given its potentially broad aspect, banks working under this definition will most likely have to choose to incur the costs of over-complying and apply the regime to standard form contracts more broadly than 'small businesses' as defined and therefore, to contracts which may fall outside the court's jurisdiction. We understand that under the legislation the default position is likely to be that the Act will apply unless it is proven otherwise.

To ensure that the current drafting of the Bill meets the Government's policy objective of assisting true small businesses, and to assist banks in reducing their compliance costs the ABA submits the Bill should be amended to ensure that any entity that is:

(i) a subsidiary or related party of a business that would not itself be a small business;

(ii) part of a corporate group that, collectively, would not be considered a small business; or

(iii) a special purpose vehicle or joint venture vehicle associated with a business that would not itself be a small business,

not to be considered a "small business" for the purposes of the legislation.

In addition, the entity should be limited to those businesses that do not exceed an annual turnover of a specified amount, for example $2 million, as applied under the Government's budget announcement for small businesses immediate deductibility of asset purchases.

Further, Clause 12BF (5) defines the business as a small business "if it employs fewer than 20 persons."

It should be clarified whether owner operators, their relatives working in the business, and casual contractors should be counted as employees.

1.2. "Upfront price" criteria

Further to the above concerns with the application of the upfront price to determine whether a financial services contract is a "small business contract" for the purpose of the proposed legislation, the ABA's understanding is that to clarify the policy intention of the Bill, Treasury has advised that for the purposes of the transaction value threshold (i.e. the $100,000 and $250,000 limits) the upfront price for financial services contracts would include both the principal and interest, while the upfront price for credit contracts would include only the principal. However, a number of additional implementation questions relating to "upfront price" remain. These are set out in detail in Appendix 1, and include application to -

- Functionally equivalent products;
- Contingencies
- No cash payments;
- Credit limits; and
- Basic deposit accounts

The ABA welcomes Treasury's intention to re-examine the explanatory material to see if these aspects can be explained clearer.

The treatment of non-credit financial services raises some quite complex considerations which, if retained in the Bill, will require further discussion with Treasury. These are set out in more detail in Section 2 of this response.

1.3. Impact of APRA regulation considerations

The ABA believes it had made clear to Treasury that the risks of lending to a business are significantly higher and different from the risk of lending to a consumer.

Management of this risk includes contractual provisions to ensure that the business maintains its financial health and that the bank is able to seek information from the business and to review the health of the business on an ongoing basis. There are factors that can detrimentally affect the financial position of a business to which consumers are not normally exposed. The ABA has previously submitted to Treasury about these factors.

Banks are prudentially supervised financial institutions regulated by the Australian Prudential Regulation Authority (APRA) which sets guidance on risk management standards that banks must meet. They are not a class of trade or ordinary creditors of a business.

As banks are subject to prudential oversight by APRA, there are special terms and conditions which are required in credit contracts. These include events of default by the business covering insolvency and pre-insolvency events; material adverse changes in its financial condition; non-compliance with financial covenants; default interest clauses; changes in a bank's regulatory capital requirements and increased costs clauses and others which could be challengeable under the proposed amendments. These types of clauses are necessary to ensure compliance with banks' legal and prudential obligations and to ensure the agreed return on their investment.

It is critical that the Bill makes provision for these types of clauses. The Bill should ensure that these terms and conditions are recognised to be legitimate terms to be included in a standard form contract with the small business. There should not be prospect of challenge to their validity on the ground they cause a significant imbalance to the parties rights and obligations arising under the contract, or that they are considered not to be for the protection of the legitimate interests of the bank.

This could be achieved if the Bill requires that when a court is considering whether to determine that a provision in a bank's standard form credit contract with a small business is unfair and consequently void, the court is to have regard to the prudential obligations and standing of the bank when considering whether the particular term is reasonably necessary to protect the legitimate interests of the bank if it is advantaged by the term.

A legislative precedent for this type of provision can be found in the National Consumer Credit Protection Act 2009 under subsection 113 (3) of the National Credit Code. Section 113 deals with the power of a court, by order, to impose a civil penalty on a credit provider for contravention of a key requirement of the Code. Subsection 113(3) provides -

> *(3) The court, in considering the imposition of a penalty, must have regard primarily to the prudential standing of any credit provider concerned, or of any subsidiary of the credit provider (within the meaning of the Corporations Act 2001), if the credit provider or subsidiary takes deposits or is a borrowing corporation (within the meaning of that Act). However, the court is to have regard to that prudential standing only if the credit provider requests the court to do so.*

1.4. Standard form contracts

The proposed Bill raises implementation questions for banks concerning the definition of a standard form contract. This is particularly an issue where a series of separate, linked contracts govern a contractual arrangement with a small business bank customer.

In a business banking context, it is commonly the case that a series of linked contracts govern the arrangements between the bank and its customer (such as the loan contract and linked securities).

It would be artificial, as the Bill currently appears to suggest, that each separate linked contract be assessed in isolation for contractual fairness and/or as to whether the Bill will apply to it.

This raises further a concern how a court would interpret its requirement to consider a contract as a whole in determining whether the term is unfair.

The ABA believes the contracts should be assessed collectively.

1.5. Third party requirements

There are also standard provisions which banks across the industry are required to include in their contracts because they are prescribed by, or reflect the requirements of, scheme rules (such as the international credit card scheme rules) which Australian banks have little or no ability to change. Accordingly the ABA submits that the definition of “small business contract” in the Bill excludes market standard contracts prescribed by industry bodies (such as ISDA’s) or contracts prescribed by foreign market participants.

1.6. Equivalent Industry Specific Legislation

The proposed legislative changes exempt “contracts which are subject to industry-specific legislation and regulation that are deemed enforceable and equivalent. Given the uncertainty of this construction, ABA requests that clarification be made to indicate which industry-specific legislation is included. In particular (including with reference to bank franchising arrangements above) ABA believes the following industry specific legislation should be deemed to be equivalent:

- Competition and Consumer (Industry Codes—Franchising) Regulation 2014. This is of particular relevance for financial advice business within banks; and
- Section 15 of the Insurance Contracts Act 1984 – where the explanation given on insurance contracts on page 61 of the RIS does not conclude whether this will be deemed equivalent

2. Exclusion of non-credit financial services

Banks offer a number of non-credit financial products to small businesses. The Bill, as currently drafted, focuses on the provision of credit services, and when applied more widely raises a number of significant implementation challenges. This particularly impacts the provision of derivative contracts, and on banks’ financial advice models. These technical challenges are set out in detail in Appendix 2, and reflect ABA members’ initial feedback and is not an exhaustive list.

ABA does not believe it was the intention of Government to regulate the terms of these contracts. Nor does ABA believe it was the policy intention to include sophisticated “small businesses” which utilise complex derivative products

Given the uncertainties and difficulties in applying the Bill’s provisions to non- credit financial services, ABA submits that these should not be included in the Bill.

3. Transitional provisions and Commencement

3.1. Transitional provisions

As the ABA understands, it is proposed that the Bill would not apply retrospectively to existing standard form contracts, only to contracts entered into on or after commencement (i.e. the day after the end of the period of 6 months beginning on the day of Royal Assent to the Bill).

However the Bill will apply to a renewal on or after commencement of a pre-existing contract to the contract as renewed and to a variation made on or after commencement to a pre-existing contract but only to the contractual term as varied unless the amendment is made to the contract which had been renewed on or after commencement and had fallen within the legislation.

The ABA is concerned that the terms used in the Bill concerning 'renewals' and 'variations' are not clear, for example, does increasing the limit on a guarantee (which requires a new guarantee to be signed) constitute a variation to the whole loan agreement? Or is it only if the terms and conditions are changed?

The ABA would appreciate a discussion with Treasury to address these uncertainties.

3.2. Commencement

The ABA does not agree with the proposed commencement date in the Bill.

To comply with the legislation banks will require sufficient time to undertake the following:-

- Identify the relevant standard form contracts that would apply to a small business customer;
- Obtain legal reviews of the terms and conditions of those contracts including security instruments covering real property and personal property security for credit contracts;
- Determining what, if any, any changes are necessary to these documents;
- Mobilising their documentary IT systems to effect the changes to fit in with the overall IT release scheduling of all of the bank's IT change requirements and taking into account the December IT "freeze" which is employed by all, banks.

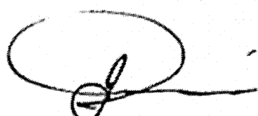
As discussed with Treasury on 8 May, **the ABA proposes a commencement date at the end of 2016 provided all of the legislative provisions (primary and subordinate) and regulatory guidance is finalised in the third quarter of 2015.**

This timing is a critical issue for member banks which the ABA requests, through Treasury, is impressed on the Government.

4. Next Steps

The ABA looks forward to early, further discussions with Treasury about these matters and will arrange as necessary for subject matter specialists to assist in these discussions.

Yours sincerely,



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Appendix 1 – Implementation challenges - credit products

1. Introduction

This Appendix sets out some implementation challenges the ABA has identified in relation to credit products. This list should not be considered exhaustive and reflects the initial concerns raised by members. The ABA welcomes Treasury's intention to re-examine the explanatory material to see if these aspects can be made clearer. The majority of these are related to the concept of "upfront costs".

As Treasury has noted the term 'upfront price' is defined in section 12BI (2) of the ASIC Act and section 26(2) of the Australian Consumer Law which refer to the three elements constituting an "upfront price".

In short, the definition refers to consideration that:

(a) is provided, or is to be provided, for the supply under the contract; and

(b) is disclosed at or before the time the contract is entered into;

but does not include any other consideration that is contingent on the occurrence or non-occurrence of a particular event.

Further, the definition adds that if credit is provided or is to be provided under the contract, the consideration referred above includes the total amount of principal that is owed under the contract.

To clarify the policy intention Treasury has advised that for the purposes of the transaction value threshold (i.e. the $100,000 and $250,000 limits) the upfront price for financial services contracts would include both the principal and interest, while the upfront price for credit contracts would include only the principal.

To assist Treasury in this regard the ABA offers the following observations and examples based on the "price" criteria.

1.1. Functionally equivalent products

There are features of some banking services products that are not characterised as credit facilities but which are functionally equivalent with credit products.

For example, it is not clear under the current drafting how banks should treat funding products which do not have a price, for example finance leases. If this gap is not addressed, the policy intent for the scope of credit products to be limited as provided in item 8 in Schedule 1 of the Bill (i.e. subclause (4) (b) amendment to section 12BF of the ASIC Act) will not be achieved.

1.2. Assessing contingencies

There is a variety of business banking products that involve the bank undertaking some form of contingent exposure at a customer's request but it is unclear whether those contingent exposures are included for the purposes of the $100,000 and $250,000 tests.

Examples include:

- A bank guarantee provided to a business customer. This involves the bank issuing a bank guarantee instrument to a third party but will not involve the bank making any actual advance of monies until (when or if) the third party beneficiary of the guarantee calls upon the bank guarantee. Such a facility is substantively the same as providing credit to a business customer, but arguably not covered because of the words in 12BI (2) of the ASIC Act.
- A merchant facility provided to a business customer which under that arrangement (which is assessed by banks in the same way as providing credit to a customer directly) the bank is

contingently exposed (under card scheme rules and other legal mechanisms) to claims by customers of the bank's business customer in the event that it becomes insolvent.
- For financial markets (derivative) transactions, most payments under a derivative contract are by their very nature contingent, and whilst they may be very substantial payment flows over the life of the derivatives, based on large what are known as Notional Amounts, there may be little or no amount which falls within the current definition of "upfront price". Derivative contracts are discussed in more detail in 3.4 below.
- Certain trade finance products where the bank's exposure is contingent.

The range of these and other transactional banking products which will require banks' reviews is substantial.

Further, common industry contracts and terms are included in agreements to reflect industry body requirements e.g. of the Australian Payments Clearing Association Limited.

There is need for a discussion with Treasury whether the Bill should be drafted to ensure all contingent bank exposures of such a nature are treated in the same way as principal under a credit contract.

There are many products under which contributions of consideration can be made into the future but are not able to be determined at the time of the contract.

1.3. Non-cash payments

It is not clear how contracts should be treated where likely consideration flowing under a contract provided to a small business to make non-cash payments may be considerably greater than $100,000 per annum. It is uncertain when the contract is entered into what the future consideration will be (and hence whether it will be "consideration that is provided or is to be provided" under 12B (2)(a)), because in the example the amount the customer will pay is determined on a per transaction basis (with future transaction volumes uncertain).

ABA requests that further guidance be provided on this point.

1.4. Credit limits

The Bill does not clarify whether it would apply to a bank providing an uncommitted credit limit to a small business where the likely usage of that credit limit is likely to exceed $100, 000.

ABA requests that further guidance be provided on this point

The Bill also does not clarify whether a series of credit facilities provided to one customer or to a corporate group are to be aggregated for the purposes of the $100,000 and 250,000 thresholds.

This can occur where a bank provides facilities structured as master facilities with an overall facility limit governed by a broader contract and sub-accounts with smaller limits governed by more specific terms and conditions. The question for ABA members is how the "upfront price" should be determined for these facilities –

- at the facility limit level; or
- at the sub-account level.

The ABA's view is that this should be assessed at the facility limit level to recognise the substance of the transaction and the contract as a whole.

1.5. Basic deposit accounts

A deposit account can be opened for consideration of $1 but the balance can grow substantially above even the $250,000 limit set in the Bill.

For example, a customer may bring their business from another bank and open an account with a notional amount and then credit large sums in the account over time as the customer transfers over payroll and other obligations. At what point should the bank be required to continue to have obligations to treat the customer as a small business for the purposes of this Bill?

The uncertainty over future contributions to the account and the potential scope of businesses whose contracts would qualify as small business contracts because they qualify as small businesses under the small business definition in the Bill could mean banks would have to review all of their business (large and small) accounts term and conditions unnecessarily and at high cost.

Addressing this problem is to ensure that the definition of the small business is clear from the outset and not simply by estimation possibly, as suggested, with an annual turnover test of the customer rather than by reference the transaction size.

ABA considers that further guidance could be provided on this point but in the interests of certainty the small business definition is by far the preferred approach.

Appendix 2: Implementation Challenges - Extension to non-credit financial service products

1. Introduction

This Appendix sets out some implementation challenges the ABA has identified in relation to extension of the proposed bill to non-credit financial services contracts. This list should not be considered exhaustive and reflects the initial concerns raised by members. The ABA welcomes Treasury's intention to re-examine the explanatory material to see if these aspects can be made clearer.

2. Derivative contracts

There is a great deal of uncertainty as to the application of the Bill to financial services which are derivatives contracts. Some of the initial identified challenges in terms of implementation are set out in detail below.

2.1. Contractual terms

Derivatives contracts are commonly traded under a master agreement arrangement, for example an International Swap Dealers Association (ISDA) Master Agreement. Such will comprise:

- an ISDA master agreement (which comprises an industry standard form and a negotiated schedule);
- the ISDA published definitions which are incorporated by reference, and;
- the one or more confirmations for trades as and when they are entered.

It is unclear how the Bill is to be applied in this scenario. Particular implementation challenges that arise include

- determining which parts of the contract are standard form and which are negotiated;
- determining at what point in time the "upfront price" is to be calculated. Commonly there are no specified trades of any value at the point in time when the master agreement is put in place; and

- In terms of transitional provisions, determining how the Bill should apply if the ISDA master agreement has been entered into between the parties before the legislation comes into effect but individual derivative trades and confirmations are transacted after the Bill's amendments are effective.

Furthermore, there are other master trading agreements other than ISDA which are entered into with entities in order to trade derivative products, which are shorter simpler documents than the ISDA framework as many smaller counterparties tend not to enter into the more complex ISDA documents.

Without the benefit of the extensive standard international terms and definitions offered under an ISDA, the terms of a master derivative trading contract may need to be open ended to allow for one party who has the operational capability to do so to undertake the calculation over certain derivative products at its discretion but acting reasonably and having regard to standard market/industry practice.

The financial institution is generally best placed to make such calculations.

2.2. "Upfront Price"

The concept of "upfront price" noted above is particularly problematic in the context of derivatives contracts, which by their very nature are largely contingent in nature. Derivative product types are many and varied. Implementation challenges here include:

- How the size of a contract can be properly assessed based on a concept of price work in relation to these type of products;
- Determining the upfront price of a contract where a premium amount which is paid upfront but is not the only payment to be made under the contract (for example as per an Option contract);
- Determining the upfront price of a contract which may not contain any non-contingent quantifiable upfront payment but only contingent payments at maturity or during the life of a trade based on a "Notional Amount" (for example as per a Swap contract);
- Determining the upfront price of a contract when a Master agreement is entered into but there are no identifiable trades at the outset, but multiple trades are entered into over a period of time (which all form part of the same contact, with netting applied). In this instance should the upfront price be calculated on a contract-by-contract basis or on an aggregate of all contracts with that entity?

2.3. Sophisticated clients

In general, the ABA does not believe it was the policy objective of the Government to provide legislative protection for "sophisticated clients" who utilise more of the out-of-the-run financial products such as derivative contracts in the first place.

Many business to business contracts are governed by (or drafted having regard to) industry standard contracts that have been utilised by businesses for many years and/or which are utilised only by "sophisticated customers" who should not be viewed – in policy terms – as "small businesses" requiring special legislative protections.

An example is a contract for the provision of derivatives pursuant to section 761D (3) and (4) of the Corporations Act. To the extent products of that nature are provided to a "retail client" under the Corporations Act (which, we note, already captures "small businesses" in certain circumstances pursuant to section 761(G)(1), (7)(b) and (12) of the Corporations Act) there are extensive existing legislative protections.

To this end, and to minimise the burden on the financial services industry of this reform, the ABA submits that the Bill should exclude sophisticated clients under section 761G (7) of the Corporations Act from its scope.

2.4. Conclusions

In the main submission, ABA states that due to these uncertainties and difficulties of application of the Bill's provisions to derivatives, contracts for derivatives under 761D(3) & (4) of the Corporations Act should not be covered under the Bill.

However if this amendment is not made, ABA invites Treasury to consider an following alternative which ensures

- A sensible test is set (rather than reference to an upfront price) so as to exclude derivatives contracts of a substantial quantum;
- If an upfront price threshold is set then in relation to derivatives contracts the upfront price should include the Notional Amount (or equivalent) of the contract similar to the retail client test for derivatives under the Corporations Act and Regulations; and
- There is a presumption that a term is not unfair if it is based on or is referenced to market standard provisions.

3. Financial Advice

Small businesses may provide financial advice services to retail clients operating under an ABA member's Australian Financial Services Licence. These agreements between an ABA member and a small business are typically "evergreen" (that is, they run until terminated for convenience by either the ABA member or the small business) and the small business pays an annual subscription. The proposed draft of the Bill raises a number of issues in relation to these arrangements.

3.1. "Upfront costs"

Since the agreement can continue for an indeterminate period the amount payable could be more or less than the $250,000 limit depending on the actual length of the agreement and the amount of the annual fee.

It is not clear from the definition how an "upfront price" is calculated in the event that the actual term of the agreement is contingent upon some future unknowable event.

ABA suggests an amendment is made so that agreements which are based on an annual fee where the duration is unknown should be excluded from the proposed legislation to give greater certainty.