Australian Finance Conference ABN 13 000 493 907 Level 8, 39 Martin Place, Sydney, 2000
Telephone: (02) 9231-5877 Facsimile: (02) 9232-5647 e-mail: afc@afc.asn.au www.afc.asn.au

7 October 2016

Independent Expert Panel
EDR Review Secretariat
Markets Group
The Treasury
Langton Crescent
Parkes ACT 2600

By email::EDRreview@treasury.gov.au

Dear Panel,

REVIEW OF THE FINANCIAL SYSTEM EXTERNAL DISPUTE RESOLUTION FRAMEWORK

Thank you for the opportunity to provide feedback on the Issues Paper, *Review of the financial system external dispute resolution framework: Consultation on the financial system external dispute resolution framework* (**EDR Issues Paper**) issued by Treasury on 9 September 2016.

The Australian Finance Conference was formed in 1958 as the national association of Finance Companies. It has since evolved into a non-institutionally based association of financiers. Our members include banks, specialist equipment financiers and general financiers providing consumer and commercial credit facilities, as well as service providers to the industry: list of members attached in Appendix 2 The AFC also provides a directorate service for a number of finance product-specific industry bodies. These affiliated entities are the Australian Equipment Lessors Association, the Australian Fleet Lessors Association, the Debtor and Invoice Finance Association, and Insurance Premium Financiers of Australia. This submission is made on behalf of the Australian Finance Conference and affiliated entities, collectively referred to as the **AFC**.

Members of the AFC are typically financial service providers and therefore "primary users", as described in the EDR Issues Paper, of the financial services external dispute resolution (**EDR**) system. As primary users AFC members have a direct and tangible interest in the equitable and efficient operation of the EDR regime. The AFC welcomes the opportunity to contribute to the Independent Expert Panel's (**IEP**) review of the EDR system.

The AFC notes that for the purposes of this submission the term "EDR system" refers to the financial system external dispute resolution framework and the term "EDR regime" refers to a specific industry scheme approved by ASIC.

Executive Summary

The AFC considers that:

(i) there are no other categories of users the IEP should consider as a part of the review the EDR system (Question 1);

(ii) the drafting of the principle of "Equity" be amended, as recommended in the submission, so that it encompasses equity across both categories of primary users and not just equity as within one category of primary user (Question 2);

(iii) the drafting of the principle of "Comparability of outcomes" be amended, as recommended in the submission, so that it encompasses comparability of outcomes across both categories of primary users and not just comparability within one category of primary user (Question 2);

(iv) a further principle of "Clear delineation", as recommended in the submission, be included in the list of principles to guide the IEP's review of the EDR system (Question 2);

(v) the IEP make clear, given the wording in paragraph 14 of the EDR Issues Paper, that consumers making complaints can only access the EDR system if they have first accessed the financial service providers internal dispute resolution system (Questions 5 to 9);

(vi) the schematic in paragraph 13 of the EDR Issues Paper be amended to include the perspective of both primary users, as recommended in the submission, to avoid any misunderstanding of the EDR system (Questions 5 to 9);

(vii) a merits based review mechanism for decisions adverse to financial services providers be built into the EDR system. The AFC does not recommend a particular model at this stage and would be pleased to further contribute to deliberations on an appropriate mechanism (Question 10);

(viii) the current jurisdictions of the existing EDR regimes are appropriate, subject to their review in accordance with the principle of clear delineation and the desirability of introducing more choice into the EDR system (Question 17);

(ix) the current monetary limits for determining EDR regime jurisdiction are appropriate, subject to their review in accordance with the principle of clear delineation and the desirability of introducing more choice into the EDR system (Question 18);

(x) it is not desirable to integrate the existing EDR regimes into "one body" (Question 38);

(xi) the IEP should as a part of its review consider options to introduce more EDR regime choice as a means of improving service standards (Question 38); and

(xii) future "independent" performance reviews be conducted by ASIC, not by the EDR scheme being reviewed, and utilise meaningful benchmarks which are common to all EDR schemes.

The reasons why AFC has reached these conclusions and recommendations are given in the body of the submission contained in Appendix 1.

AFC's general views and particularly in relation to (vii) above derive from the history of EDR in the finance sector. When in the late 1980s the ABIO (FOS's progenitor) was established, finance regulation was state-based as were the Fair Trading/Consumer Affairs Government agencies. In volunteering into the ABIO, its members consciously ceded several of their legal and contractual rights and remedies to promote an improved consumer outcome. For several years now, finance and related fair trading regulation have been at the Commonwealth level as are the regulators in ASIC and ACCC. Moreover EDRS 'membership' is now compulsory as an ACL or AFSL condition. In such circumstances, the EDRS framework should reflect such compulsion and processes should be remedied accordingly.

If you have any queries in relation to the AFC submission please do not hesitate to contact me on (02) 9231 5877 or Paul Stacey, Associate Director – Policy on (02) 9225 3810.

Yours truly,

Ron Hardaker
Executive Director

APPENDIX 1

Submission

1. Question 1: Are there other categories of users that should be considered as a part of the review?

1.1 Paragraph 10 of the EDR Issues Paper describes two categories of "primary user". These are consumers who make complaints (**Complainants**) and the financial service providers who are the respondents to the complaints (**Respondents**).

1.2 The AFC considers that there are no other categories of users who should be considered as a part of the review given the nature of The EDR system.

2. Question 2: Do you agree with the way in which the panel has defined the principles outlined in the terms of reference for the review? Are there other principles that should be considered in the design of an EDR and complaints framework?

2.1 The AFC is of the view that the EDR system forms an important and integral part of Australia's financial system. The policy intent of the EDR system is to provide a low cost and timelier alternative to resolve disputes between certain complainant consumers and respondent financial service providers.

2.2 The EDR system as an alternative dispute resolution system is by definition a departure from, and exists outside, the judicial system which serves to maintain the rule of law, which is an essential prerequisite to economic commerce and broader rights. In the judicial system the rights of participants are equal.

2.3 The EDR system involves a rebalancing of the rights of Complainants and Respondents as compared to the judicial system. This is a matter of policy design. It is perceived that the potential benefits of greater access to justice for Complainant, in terms of ease and speed of access, to outweigh the detriment to Respondents of the abrogation of their rights to access justice through the courts etc.

2.4 It is important to recognise that while the EDR system involves two categories of primary user it is asymmetric by design. The two sets of primary user do not have equal rights within the system. Access is voluntary for Complainants: participation is compulsory for financial system providers. Access is free for Complainants: financial system providers bear the entire cost (of the EDR system). Complainants choose which system (judicial or EDR?) to prosecute their complaint: Respondents are bound by an EDR regime's finding and are denied a right of appeal, except on a matter of process.

2.5 Therefore, while it is true that the EDR system has the potential to provide Complainants with the benefits of greater speed and access, the EDR also has the potential to create injustice to Respondents, particularly smaller financial service providers.

2.6 Given the EDR system is an exception to the justice system and asymmetric by design:

(i) the jurisdiction of EDR regimes should be tightly defined; and

(ii) the protocols governing the conduct of EDR regimes should explicitly impose an obligation on EDR regimes to objectively balance the competing interests of the Complainant and financial service provider when reaching decisions.

2.7 If the operational functioning of EDR regimes are not constrained in this manner the risk of the EDR system producing unjust outcomes will be magnified to the detriment of financial system efficiency.

2.8 For example, proceedings before a judicial forum are subject to the rules of evidence. The rules of evidence serve to objectively establish the veracity of the claimed wrong doing. In the EDR system the EDR regimes are not subject to the rules of evidence. Absent rules of evidence, or any other requirement to objectively establish the truth of the claim, this can lead to a culture of bias. This bias evidences itself in a presumption of wrong-doing by the Respondent in which Complainants claims are taken at face value. This is the experience of some members of the AFC of the existing EDR regimes.

2.9 Further, where there is a culture of bias, perceived or actual, and this is combined with low to no barriers of entry (for Complainants) plus the practices of credit repair agents this can lead *"to gaming"* of the EDR system.

2.10 At an entity level Respondents, particularly smaller financial service providers, will make the economic calculation that it is cheaper to remove a default listing against a creditor, or write off a balance owing, than contest a claim in the EDR system. This results in injustice to the financial service provider who has behaved properly in recording the default or debt.

2.11 At a financial system level there is also a detriment as demonstrably non-credit worthy borrowers will continue to be able to access credit as a result of the effective rewriting of their credit history. This, in turn, compounds the injustice at an entity level as other financial service providers will experience financial loss on subsequent defaults. The rules governing EDR schemes include the power to exclude hearing vexatious complaints. But these do not, in practice, mitigate against this outcome.

2.12 The AFC agrees that the IEP should conduct its review in accordance with the seven principles outlined in paragraph 7 of the EDR Issues Paper. The principles should recognise the legitimate interests of both primary users of the EDR system. However, as currently framed two of the principles inappropriately exclude a consideration of Respondents' interest in the EDR system. These are the principles of "Equity" and "Comparability of outcomes".

2.13 The principle of "Equity" is defined as "users should face minimal cost barriers and be able to easily access the system. As drafted the principle of equity only applies to primary users who are Complainants: all Complainants should face minimal cost barriers and be able to easily access the system. As drafted the IEP is **not** to have regard to equity as between different categories of primary users, namely complainants and respondent financial service providers. This is inequitable in a review system which by policy design rebalances the rights of the two sets of users away from a starting point of equality.

2.14 The principle of "Comparability of outcomes" is similarly drafted to only have regard to comparability of outcomes as between primary users who are Complainants. As drafted the IEP is **not** to have regard to comparability of outcomes between different categories of primary users, namely Complainants and respondent financial service providers.

2.15 The AFC recommends that the principles be amended as follows:

(i) the principle of "Equity" be amended as underlined to read:

"users who are complainants should face minimal cost barriers and be able to easily access the system and users who are financial service providers should not face excessive costs or be compelled to respond to vexatious complaints;"

(ii) the principle of "Comparability of outcomes" be amended as underlined to read:

"users who are complainants and who have similar complaints, and users who are financial service providers who are respondents to similar complaints, (for example, in relation to similar financial products) should receive similar outcomes; and" and

(iii) a new principle of "Clear delineation" should be added and to read as underlined:

*"**Clear delineation**: the jurisdiction of EDS regimes should be clearly and tightly defined and dispute resolution processes must objectively balance the competing interests of all users."*

3. Questions 5 - 9: Internal dispute resolution

3.1 Financial services providers and credit providers, as noted at paragraph 15 of the EDR Issues Paper, are required by law to have internal dispute resolution (**IDR**) procedures that meet ASIC requirements. The implementation and operation of IDR procedures necessarily involves the incurring of costs by these entities. Given that these costs are mandatory, rather than voluntary, it follows that it should also be mandatory for Complainants to access IDR before they are entitled to access the EDR system. If not, then as a matter of economic efficiency regulatory costs are built into the financial system, ultimately leading to higher prices for domestic consumers and a lack of international competitiveness for Australian financial service providers, for no good policy reason.

3.2 In the light of this policy logic the AFC interprets the reference to "a consumer's first *option*" (emphasis added) in paragraph 14 of the EDR Issues Paper as referring to "a consumer's first *step*". The AFC understands that under the present EDR system complainants do not have an option to access IDR or EDR at the outset. Complainants must first seek to have their complaint resolved via IDR and only once the IDR process has been completed can a complainant then access the EDR system.

3.3 To the extent AFC's understanding of the present EDR system is incorrect and complainants have the option of accessing either IDR or EDR at the outset then the AFC submits, on policy grounds, that complainants must first seek to resolve their complaint through IDR before they can access EDR.

3.4 The AFC also notes that the schematic in paragraph 13 of the EDR Issues Paper is potentially misleading. The schematic seeks to visually represent the entirety of the financial dispute resolution framework. The financial dispute resolution framework encompasses two categories of primary user: Complainants and Respondents.

However, the schematic only visually represents the operation of the financial dispute resolution framework from the perspective of one category of primary user: Complainants.

3.5 As a result of the incomplete schematic the operation of the financial dispute resolution framework could be misunderstood by the casual user. For example, it is *not correct* to say for Respondents that "Recourse can be sought through the court system". Respondents only have a limited right of appeal to the court system in highly constrained circumstances. It would be relatively easy to amend the schematic to avoid any such misunderstanding

3.6 The AFC recommends that the schematic in paragraph 13 of the EDR Issues Paper be amended by inserting a further row of three boxes at the bottom of the schematic illustrating the operation of the financial dispute resolution framework from the perspective of the respondent.

4. Question 10: What is an appropriate level of regulatory oversight for the EDR and complaints arrangements framework

4.1 The existing EDR system is, in effect, a separate legal system which governs the resolution of certain disputes relating to financial products. The dollar amounts of those disputes are relatively small amounts in financial system terms, but in absolute terms may be significant, in isolation or cumulatively, from the perspective of Complainants or Respondents, particularly smaller financial service providers.

4.2 All legal systems inherently run the risk of ossifying over time resulting in unjust outcomes. This risk arises from decision makers' tendency to follow earlier decisions when reaching conclusions on current disputes. In the judicial system this is referred to as the doctrine of precedence. The best known example of the related risk is the law of equity. This developed as an alternate body of law, and at one time a separate court system, to overcome evident injustices arising from the application of precedent in the common law. In the legal system this risk of ossification and injustice is mitigated by the appellate system – higher courts are not bound by the decisions of lower courts, and also by parliament which can legislate new laws to achieve desired outcomes.

4.3 The EDR system, as a quasi-judicial system, is at the same risk of ossification leading to unjust results. This quasi-judicial nature is, for example evident, in the Financial Ombudsman Services (**FOS**) consultation paper on *"Expansion of FOS's Small Business Jurisdiction"* (**FOS SME Consultation**). At page 9 of the FOS SME Consultation FOS proposes that it have, in substance, the power to subpoena third parties to attend conferences and by implication impose penalties for failure to attend. These are judicial powers in nature.

4.4 The risk of ossification of the EDR system leading to unjust results arises from:

(i) an application of the principle of comparability of outcomes. This means that EDR decision makers will tend to follow earlier decisions when reaching conclusions on current disputes; and

(ii) the lack of a self-correction mechanism in the EDR system to ensure that unjust outcomes are not replicated, due to very limited rights of appeal for Respondents.

4.5 At present the only oversight of the EDR system is that provided by ASIC. However, as noted at paragraph 23 of the EDR Issues Paper, "ASIC's oversight role is limited to high level policy settings" and "ASIC does not intervene in the decision-making process of the scheme".

4.6 The current framework, therefore, contains no merits based oversight of decisions adverse to Respondents. In the judicial system merits based oversight of decisions adverse to Respondents is provided by appeal to a higher court. The EDR system is therefore inherently prone to ossifying unjust findings adverse to Respondents.

4.7 This structural defect also leaves financial service providers, particularly smaller financial service providers, vulnerable to pressure to settle un-meritorious complaints in IDR brought by third party credit repairers on behalf of clients. This, in turn, leads to distortions in the system obscuring the true situation, as well as injustice to Respondents.

4.8 Credit repairers are businesses which charge consumers substantial amounts of money to arrange for the removal of credit default listings noted on a consumer's credit bureau file. This removal enables the consumer to readily obtain further credit. These businesses often use templated letters alleging that the default listing suffers from all possible technical defects, each one of which has to be rebutted. Many credit providers simply remove credit defaults to avoid escalating EDR complaint fees associated with defending valid default listings, as illustrated in the following example. The activities of credit repair companies have expanded significantly since the introduction of mandatory EDR scheme membership.

4.9 Credit repairers act for multiple clients. They do not act for single clients in isolation. Respondents similarly extend credit to multiple clients. However, a Respondent subject to an adverse finding, unlike a Complainant, cannot access the court system to revisit the merits of the finding. Therefore, if a credit repairer is able to obtain a positive EDR regime finding on behalf of a single client (which by definition is an adverse finding for the Respondent) it can replicate that outcome across its client base (since the finding is not subject to a merits review and will be followed by the EDR regime in subsequent like disputes)

4.10 At the credit repairer entity level, the absence of merits review and the principle of comparability of outcomes at a system level, means from its business perspective it can multiply its income by a factor of X from a single positive finding (X being the number of individuals in its client base in similar circumstances). The very design of the EDR system serves as an incentive for credit repairers to adopt a quasi-class action approach so as to multiply business income.

4.11 At the financial service providers entity level, they bear the cost of free access to the EDR system by Complainants. They also bear any further costs imposed by the EDR regime in resolving a complaint. For example, in one recent example the Complainant claimed that their loan contract with an AFC member was fraudulently signed. The particular EDS regime dealing with the complaint wanted the Respondent to engage a fraud expert to rebut the claim at a cost of $4 - $5,000 dollars. Further, Respondents know, like credit repairers, that if a complaint goes through IDR and is later subject to a negative EDR finding then that economic loss will similarly be multiplied. Therefore, where the amount of the disputed debt is less than the likely cost of contesting the claim in EDR, including the possible multiplying effect, it makes economic sense for the Respondent to settle the complaint in IDR, notwithstanding that fraud had been committed by the Claimant.

4.12 At a system level there has, in these circumstances, been a transfer of economic value from the financial service provider to the credit repairer for no productive output and un-credit worthy individuals are able to continue accessing credit. The AFC submits that this is not a good policy outcome and at arise solely as a consequence of a structural defect in the EDR system.

4.13 The AFC recommends that a merits based review mechanism for decisions adverse to Respondants be built into the EDR system. The AFC does not at this stage recommend a particular model. Depending on the model used the scope of the review might extend to the EDR process itself, i.e. *how* an EDR scheme handled a particular complaint. The AFC would be happy to contribute to any further consultation on this aspect of the EDR system.

5. Questions 19 & 20: Jurisdiction and monetary limits

5.1 The EDR Issues Paper asks on page 17 at:

- "Question 19. Are the jurisdictions of the existing EDR schemes and complaints arrangements appropriate? If not, why not?"; and
- "Question 20. Are the current monetary limits for determining jurisdiction fit-for-purpose? If not, what should be the new monetary limit? Is there a rationale for the monetary limit to vary between products?"

5.2 The AFC is of the view that the existing jurisdictions and monetary limits are appropriate. The AFC's rationale for this view is outlined in its submission to the FOS SME Consultation which is attached in Annexure 2. This view also accords with the AFC recommended principle of Clear Delineation described above.

6. Question 38: Is integration of the existing arrangements desirable? What would be the merits and limitations of further integration?

6.1 The AFC is of the view that the EDR system functions better as a result of the existence of multiple EDR schemes. This is due to a combination of factors, principally:

(i) it enables at a system level a more differentiated approach as each EDR scheme over time develops a nuanced staff skill set appropriate to the type of complaints it predominantly helps resolve. This more differentiated approach is likely to lead to more equitable outcomes (for both Complainants and Respondents) given the diverse nature of the banking and financial services industry.

For example, in AFC experience one of the existing EDR regimes in practice treats the Banking Code of Practice (**BCP**) as industry best practice as its default position for all Respondents, regardless of whether or not they are banks. This leads to anomalous outcomes when that EDR regime applies its view of industry best practice to disputes involving Respondents who are financiers and where industry practice is different. See for example the AFS submission to the FOS Small Business Consultation in Appendix 2; and

(ii) it introduces a degree of competitive tension into the EDR system which would otherwise be lacking.

The CameronRalph Independent Review of FOS operations in 2013 demonstrates the value of being able to benchmark like organisations. CameronRalph found that FOS needed to markedly improve its performance, including the professionalism of its operations, clarity and quality of decisions and the need to lift the standard of its human resource management. As a direct result of this benchmarking exercise, FOS implemented a number of significant improvements to its complaint handling processes. For example, at page 60 of its review CameronRalph recommended that FOS adopt an approach akin to that of CIO for financial hardship variations, which it subsequently did.

6.2 Further, it is AFC's view that the EDR system would benefit from a greater level of competition than its current duopolistic nature. The AFC is unconvinced that the EDR system as a whole has benefited materially from the merger of five schemes into FOS in 2008.

6.3 The AFC does not consider that further consolidation of EDR regimes will improve operation of the EDR system and, indeed, recommends that the IEP consider options to increase the level of choice within the system for financial service providers. The AFC also recommends that future "independent" performance reviews by conducted by ASIC, not the EDR scheme being reviewed, and utilise meaningful benchmarks which are common to all EDR schemes.

Australian Finance Conference ABN 13 000 493 907 Level 8, 39 Martin Place, Sydney, 2000
Telephone: (02) 9231-5877 Facsimile: (02) 9232-5647 e-mail: afc@afc.asn.au www.afc.asn.au

APPENDIX 2

7 October 2016

Ms Jenny Peachey
Executive General Manager - Strategic Review
Financial Ombudsman Service Limited
GPO Box 3
Melbourne VIC 3001

By email:JPeachey@FOS.org.au

Dear Jenny,

CONSULTATION PAPER ON EXPANSION OF FOS'S SMALL BUSINESS JURISDICTION

Thank you for the invitation to provide feedback on the *Expansion of FOS's Small Business Jurisdiction Consultation Paper* (**FOS SME Consultation**) issued by the Financial Ombudsman Service (**FOS**) in August 2016.

The Australian Finance Conference was formed in 1958 as the national association of Finance Companies. It has since evolved into a non-institutionally based association of financiers. Our members include banks, specialist equipment financiers and general financiers providing consumer and commercial credit facilities (including to small business), as well as service providers to the industry: list of members attached in Appendix 2 The AFC also provides a directorate service for a number of finance product-specific industry bodies. These affiliated entities are the Australian Equipment Lessors Association, the Australian Fleet Lessors Association, the Debtor and Invoice Finance Association, and Insurance Premium Financiers of Australia. This submission is made on behalf of the Australian Finance Conference and affiliated entities, collectively referred to as the **AFC**.

Members of the AFC are typically Financial Services Providers, for the purposes of FOS's Terms of Reference (**TOR**), and therefore have a direct and tangible interest in the equitable and efficient operation of the FOS external dispute resolution (**EDR**) regime. As stakeholders in the regime AFC members welcome the opportunity to contribute their views on the possible extension of FOS's small business jurisdiction.

The AFC notes the concurrent work of the independent expert panel (**Expert Panel**) on the financial system EDR framework, of which the FOS is one part. The Expert Panel released on 9 September 2016 an issues paper titled *'Review Of The Financial System External Dispute Resolution Framework'* (**EP Issues Paper**). Outlined in the EP Issues Paper are seven principles which are to guide the Expert Panel's review, namely: efficiency, equity, complexity, transparency, accountability, comparability of outcomes and regulatory costs. As a matter of system integrity the AFC considers that these same principles should similarly be applied when assessing the merit of the proposals in the FOS SME Consultation. The AFC has prepared its submission on this basis.

As a matter of process the AFC also has some concern that the FOS SME Consultation conflates into a single consultation two distinct, but related, issues which should be subject to separate consultative processes. The first issue is whether or not FOS's jurisdiction should be expanded to include a larger number of small businesses. The second and subsequent issue is if a formal decision is reached, what changes need to made to FOS' legal and operational structure.

The risk of conflating the two deliberations into a single exercise is that the ramifications of the change, if made, might not be fully considered. For example, the current TOR is rather broad in nature and tends to be interpreted in a certain way on a rather ad hoc, case by case, basis. If FOS' small business jurisdiction were expanded it may be appropriate for the TOR to be redrafted in its entirety using more prescriptive and tighter language. This might be needed to accommodate the distinctions between banks and other financiers and consumers and small businesses and which regulations and legislation governs which. However, nowhere in the FOS SME Consultation is this possibility considered. The inclusion of potentially worthy, but extraneous, changes to the issue of whether FOS' small business jurisdiction in the FOS SME Consultation only further muddies the process.

Before turning to AFC's specific comments in the context of this Consultation, it would be remiss not to take a broader perspective and ask whether FOS should now have an SME jurisdiction at all. In the late 1980s when FOS's progenitor (the ABIO) was established, finance regulation was state-based as were the Fair Trading/Consumer Affairs Government agencies and the vital role small business plays in the modern economy was barely recognized. In volunteering into the ABIO, its members consciously ceded several of their legal and contractual rights and remedies to promote an improved consumer outcome.

For several years now, finance and related fair trading regulation have been at the Commonwealth level as are the regulators in ASIC and ACCC. The importance of SMEs is now widely promoted and EDRS 'membership' is compulsory as an ACL or AFSL condition. Moreover there is now an increasingly resourced and mandated Australian Small Business & Family Enterprise Ombudsman, as well as several State Small Business Ombudsman services.

Executive Summary

The AFR considers that:

(i) FOS should remove its existing Small Business definition and replacing it with a financial data based test which accords with contemporary regulatory, business and lending practices and the Expert Panel's guiding principles;

(ii) the new Small Business test, reflecting the fact that a financier cannot with compliance certainty identify the number of a borrower's employees (even at the outset), be a single turnover test which limits eligibility to a business with an annual turnover of no more than $2m for reasons of simplicity and to align with the taxation system;

(iii) the current monetary limits in relation to small business disputes should remain unchanged (Proposal 1);

(iv) FOS should not have the power to compulsorily force third party attendance at conferences (Proposal 1.2);

(v) FOS' jurisdiction should not be increased to vary unregulated contracts for financial hardship, absent a compelling reason to do so (Proposal 2.1);

(vi) any proposal to increase FOS's jurisdiction to vary unregulated contracts for financial hardship should be subject to a separate consultation since the proposal is not restricted to unregulated contracts to small business (Proposal 2.1);

(vii) its existing grouping provision should be removed and replaced with a provision which is consistent with the new Small Business definition recommended in (i) above (Proposal 3.1);

(viii) the proposed changes to the existing grouping provision are appropriate if the existing Small Business definition is not replaced (Proposal 3.1);

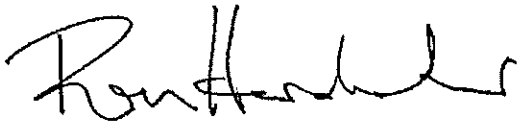
(ix) there is no reason for FOS to establish an additional specialist unit and impose additional fees in the event its small business jurisdiction is increased (Proposal 4.1); and

(x) the proposed changes in respect of paid agents is a useful step forward, but they are unrelated to the proposed small business jurisdiction extension. The actions of paid agents pose systemic issues to the overall FOS EDR regime. The proposed changes should be more fully considered as a part of a separate and broader consultation into the role of paid agents within the FOS EDR regime (Proposal 6.5).

The reasons why AFC has reached these conclusions and recommendations are given in the body of the submission contained in Appendix 1.

If you have any queries in relation to the AFC submission please do not hesitate to contact me on (02) 9231 5877 or Paul Stacey, Associate Director – Policy on (02) 9225 3810.

Yours truly,



Ron Hardaker
Executive Director

APPENDIX 1

Submission

1. Existing definition of Small Business is no longer appropriate

1.1 Paragraph 20.1 of the TOR defines Small Business as follows:

"Small Business" means a business that, at the time of the act or omission by the Financial Services Provider that gave rise to the Dispute:
a) if the business is or includes the manufacture of goods: had less than 100 employees; or
b) otherwise: had less than 20 employees.

1.2 The paragraph 20.1, TOR definition of Small Business appears to have been adopted, with minor contextual variation, from section 12BC(2) of the *Australian Securities and Investments Corporation Act 2001* (**ASIC 2001 Act**), which provides:

(2) For the purposes of subsection (1):
***small business** means a business employing less than:*
(a) if the business is or includes the manufacture of goods—100 people; or
(b) otherwise—20 people.

1.3 Two observations can usefully be made in respect of this statutory definition of small business in the context of the FOS SME Consultation:

(a) the section 12BC(2) definition was incorporated into the ASIC 2001 Act in its entirety and without alteration from the predecessor *Australian Securities and Investments Commission Act 1989* (**ASIC 1989 Act**).

The statutory definition has therefore existed unaltered, and possibly unconsidered, for at least 15 years and possibly as long as 26 years. However, over this same period there has been significant change in the structure and functioning of the domestic economy – for example, the advent of the digital economy, increased outsourcing and casualization of the workforce. So too there has been significant change to the financial and broader regulatory framework within which businesses operate; and

(b) the section 12BC(2) definition of small business operates, not in isolation but in conjunction, with "the prescribed amount" of the price of the financial services acquired. The prescribed amount is $40,000, which is very small in commercial terms, and this limitation applies unless the service is a typical business expense.. The purpose of combining the definitions of small business AND prescribed amount in a single test is to ensure that section 12BC only extends to small businesses whose circumstances are broadly analogous to consumers.

This principle, underpinning the statutory definition from which the FOS definition of small business is drawn, that a consumer based EDR scheme should only be accessed by small businesses who are broadly analogous to consumers must be recalled. It is founded on legitimate concerns of equity, equality and efficiency. For example, in the context of the FOS SME Consultation can it be credibly said the circumstances of a small business who can borrow $10m are analogous to that of the median Australian employee earning $80,000 per annum?

1.4 It is usual for business regulators to identify a business, or entity, as small by reference to financial measures. Financial measures have the advantage of being objective and readily available: Examples include:

(a) taxation regulation. Australia's taxation system provides concessional treatment to small businesses in a number of specific circumstances. Ordinarily a business can only access these if its annual turnover does not exceed $2 million: see for example the definition of "small business entity", section 328.110, *Income Tax Assessment Act 1997*. Further, the Australian Taxation Office (**ATO**) categorises businesses into market segments by reference to turnover for administrative purposes. For example, "a micro business" is defined as an entity having a turnover between $75,000 and $2m. These micro-businesses are arguably those whose business whose circumstances are most broadly analogous to consumers eligible to access the FOS EDR; and

(b) financial reporting regulation. Small proprietary companies are subject to reduced financial reporting requirements. A proprietary company is small where it satisfies two of a turnover test (of less than $25m), an assets test (of less than $12.5m, and an employee test (of less than 50 employees): see section 45A(2), *Corporations Act 2001*. Under this test it is possible for a proprietary company to have 1,000 employees yet still be classified as small and equally for a proprietary company to have 10 employees and not be small.

1.5 Turnover and asset tests are therefore incorporated into business accounting and tax systems. These tests determine the amount and character of financial data a business collects, the financial statements it prepares and the income tax liability it reports to the ATO. These tests are therefore of critical importance. The correct application of the tests is ordinarily checked by internal controls and by external audit. In contrast, the number of employees is generally not a relevant measure. Turnover and asset tests are therefore widely understood by commercial people, and regulators, as providing an objective measure of when a business is small.

1.6 In the specific context of the financial system turnover and asset tests provide objective, credible and testable evidence of a creditor business's capacity to pay. Credit assessment procedures invariably require a small business applicant to provide details of turnover and assets. The applicant will ordinarily satisfy this requirement by providing a copy of its prior year tax return as lodged with the ATO together with a copy of current and prior year trading accounts. These are then subject to "a debt service exercise" under which the profit and loss account is stress tested by financial modelling to assess capacity to pay.

1.7 In contrast, the number of persons employed by an applicant (including other members of a group) has little, to no relevance, in determining the applicant's capacity to service the debt. It is not a relevant measure therefore the data is not collected for credit purposes. Further, even where data on the number of employees is collected it cannot be independently tested again rendering it irrelevant.

1.8 The AFC is strongly of the view that the scope of FOS's jurisdiction in respect of small business should only be extended to the extent the enlargement is consistent with the principles of efficiency, equity, complexity, transparency, accountability, comparability of outcomes and regulatory costs. This situation will be meet when the circumstances of a small business are broadly analogous to that of a consumer.

1.9 The gateway into the FOS EDR system is the initial assessment of credit. At that point both applicant consumers and small businesses are assessed by reference to their capacity to service the debt. In the case of consumers credit lenders require evidence of income and assets. In the case of small business credit lenders require evidence of turnover and assets. It follows, and is in accordance with the principles

of efficiency, equity, complexity and regulatory costs, that gateway test of small business should also be based on turnover.

1.10 The AFC therefore recommends that the FOS amend its TOR by removing the existing paragraph 20.1 definition of Small Business and replacing it with a financial data based test which accords with contemporary regulatory, business and lending practices and which accords with the Expert Panel's guiding principles.

1.11 For AFC recommends that this new Small Business test be a single turnover test which limits eligibility to a business with an annual turnover of no more than $2m. AFC recommends that the test be solely based on turnover, and not have regard to assets, for reasons of simplicity. This test aligns to the small business test used in the taxation system and should be applied at the point in time at which credit is extended

2. Proposal 1.1: Increased monetary limits

2.1 The FOS SME Consultation proposes to increase the existing monetary limits by a factor of between 4 and 6.47, or in absolute monetary terms to a minimum of $2m and a maximum of $10m, depending upon FOS's classification of dispute type.

2.2 Paragraph 19 of the EP Issues Paper describes the purpose of an EDR scheme, such as FOS, in the following terms:

"EDR provides an avenue for people to resolve their disputes without going through adversarial court processes. It allows for disputes to be completed in a timelier manner and at a lower cost than the formal legal system. EDR's focus on 'fairness' has the potential to produce results that are more satisfactory to participants. In addition to providing a forum for resolving individual consumer complaints, EDR also allows for the identification and addressing of systemic issues within an industry."

2.3 However, these perceived benefits and potential outcomes come at the detriment of the removal of the due process safeguards of the judicial system. In particular, the absence of the requirement to follow rules of evidence, the common law and the effective removal of appeal rights, except in very limited circumstances. The EDR therefore also has the potential to produce results that are less satisfactory to participants.

2.4 At a financial system level the existing policy assessment is that this trade-off is appropriate in circumstances where the complainant is a consumer, or a small business whose circumstances are genuinely analogous to a consumer, and the complainant has also has already gone through an internal dispute resolution (**IDR**) process.

2.5 The underlying reason why this trade-off is appropriate is because the economic resources available to consumers, who are ordinarily individuals, to avail themselves of the judicial system is generally less than those available to credit providers, who are ordinarily businesses. It is this disparity in economic resources which is the primary reason why access to an EDR can result in "timelier" and fairer outcome. It is not because of an inability of the judicial system to provide fair and appropriately timely outcomes. It also follows that the force of the rationale to restrict access to justice via an EDR diminishes together with the decline in the disparity in economic resources.

2.6 The AFC agrees with the existing policy assessment that this trade-off is appropriate where the circumstances of a small business are broadly analogous to that of a

consumer, as evidenced by section 12BC of the ASIC 2001. The AFC does not agree with the proposition that small business complainants should be able to restrict access to justice to an EDR where their circumstances are no longer analogous to that of an individual consumer. In this situation the policy rationale restricting access to justice to an EDR no longer applies. The outcome will be the inequitable treatment of the credit provider who is deprived of the protections of the judicial system for no good reason.

2.7 The AFC considers that there is no good policy reason, given the rationale of FOS EDS role within the financial system, to increase the existing current monetary limits which are already generous.

3. Proposal 1.2: Right to compel third party attendance at conferences

3.1 The FOS SME Consultation notes on page 9 that in FOS's experience of dealing with "small business disputes and other complex matters" conferences are an effective way to help resolve these disputes. Further, and given that complexity, FOS proposes to amend its TOR to give itself the power to make conferences compulsory and to compel third party attendance.

3.2 FOS does not outline in the FOS SME Consultation the penalties it proposes to impose on third parties who fail to attend. However, it must necessarily follow that FOS is able to impose penalties if it is to have the power to compel third party attendance. If FOS does not also have the power to impose penalties then logically any third party attendance will not be compulsory.

3.3 The AFC agrees with FOS's assessment that small business disputes are "complex matters".

3.4 The AFC is deeply concerned, from a rule of law perspective, at the suggestion that FOS confer on itself (by self-amendment of its TOR) judicial powers of subpoena and punishment in order to enable it to deal with that complexity. FOS has no right founded in contract to require attendance since third parties are not a party to the TOR. Therefore, any capacity to require their attendance would be judicial in nature. This suggestion is particularly troubling given the abrogation of judicial rights inherent within the FOS EDR regime.

3.5 The AFC is of the view that such a change would likely lead to unfair outcomes and possibly reduced timeliness contrary to the objects of FOS. Proceedings under FOS are without prejudice, do not abide by the rules of evidence, and take complainant submissions on face value. Given these conditions, third parties would be able to make allegations without a burden of proof or risk of being taken to court. This will lead to unfair outcomes to the credit provider. As a practical matter delays may arise due to scheduling difficulties in arranging for a greater number of persons to attend the conference.

3.6 The AFC considers that the better view is that given:

(a) these disputes are complex;
(b) FOS perceived need to acquire judicial-like powers to deal with that complexity; and
(c) the likelihood that conferment of this power will lead to unfair outcomes

these are all good reasons why small business disputes should continue to be dealt with by the courts

3.7 The AFC is strongly of the view that the FOS should not have the power to compulsorily force third party attendance at conferences.

4. Proposal 2.1: Extension of jurisdiction to be able to award debt forgiveness or variation for all unregulated contracts (not just with small business) for financial hardship

4.1 The rationale for this proposal, as outlined in page 12 of the FOS SME Consultation, is broadly FOS has this power under the National Credit Code (NCC). Under the Code of Banking Practice (CBP) the banks undertake to have regard to financial hardship. The CBP "reflects good industry practice". Therefore, the FOS should have the power to vary contracts which are not made to consumers AND which are not regulated under the NCC AND are made by entities others than banks.

4.2 This reasoning is patently fallacious. The CBP is, by definition, only indicative of good industry practice for banks. Therefore, by definition, it is not reflective of good industry practice for entities other than banks in other areas of financial services and which appropriately have no input in to development of the CBP. Therefore, by definition, the existence CBP does not provide any support this proposal by FOS. What is inappropriate, though, is for FOS to assess the existence of maladministration in relation to non-bank business lending by reference to criteria which does not apply to that lending, such as the responsible lending and code provisions,

4.3 The AFC is also concerned as a matter of process that this proposal is contained within the FOS SME Consultation. Given that the proposal has application beyond credit arrangements with small business the AFC considers it should be subject to a separate consultation process.

4.4 The AFC opposes the extension of jurisdiction to award debt forgiveness or vary unregulated contracts for financial hardship given the absence of a compelling argument in support of this proposal.

5. Proposal 3.1: Amendment to grouping rule

5.1 The FOS proposes to make a minor amendment to the grouping provision in paragraph 5.1 p) of the TOR so as to better align it with the definition of Small Business in paragraph 20.1 of the TOR.

5.2 The AFC is of the view that the definition of Small Business in paragraph 20.1 should be replaced with a financial data based test which accords with contemporary regulatory, business and lending practices and which accords with the Expert Panel's guiding principles. It follows that AFC considers that the grouping provision in paragraph 5.1 p) should be similarly replaced.

5.3 As a general observation the AFC considers that greater guidance could be given as to the time at which grouping should be tested, regardless of whether the test is a financial data based test or an employee number test. That point in time should, broadly, be the point in time at which credit is extended.

5.4 The AFC has no objection to the proposal in the event that the definition of Small Business is not improved.

6. Proposal 4.1: Specialist business unit and additional fees

6.1 The FOS proposes, at page 14 of the FOS SME Consultation" so establish a "dedicated specialist business unit ... [as a part] of our existing Banking and Finance Team". To fund the establishment of the unit FOS proposes to level additional fees on credit providers.

6.2 The AFC does not support the proposed expansion of FOS jurisdiction in relation to small business in the manner contemplated in the FOS SME Consultation: see paragraphs 1.8 and 2.7.

6.3 The AFC agrees with FOS' view that the small business disputes which currently fall within its jurisdiction are complex: see paragraph 3.1. The AFC does not consider that the complexity of these disputes will increase merely because the monetary limits are increased to the amounts indicated in Proposal 1.1.

6.4 If FOS considers it already has the necessary expertise to deal with the small business disputes which fall within its existing jurisdiction AND there is no increase in complexity merely from increasing the monetary limit THEN it follows that there is no need to establish a separate business unit and impose additional costs on credit providers.

6.5 Alternatively, if FOS considers that it doesn't already have the necessary expertise to deal with existing small business disputes, then that is all the more reason why its jurisdiction should not be extended to include a greater number of such disputes. In either case the AFC does not see a convincing reason to establish a separate unit and impose greater costs on business.

6.6 The AFC considers there is evidence that the FOS EDR regime is being gamed by paid agents and/or small business customers. As a result of this activity some individuals are able to receive credit which from they otherwise would not be able to obtain via exploiting weaknesses in the system to in effect rewrite their credit histories. The AFC considers that one of the features of the existing FOS EDR regime which enables this gaming, notwithstanding paragraph 6.1d) of the TOR, is the structure of FOS levying fees only one party. Therefore levying yet more fees, without providing additional safeguards, will only result in more gaming of the system. See paragraphs 7.1 to 7.4 for further comment on paid agents.

6.7 The AFC does not consider that it is necessary for the FOS to create an additional specialist unit and impose additional fees in the event its jurisdiction in relation to small business disputes is increased.

7. Proposal 6.5: Paid agents

7.1 FOS proposes a minor amendment to paragraph 6.1d) of the TOR to reflect that it no longer includes "a separate acceptance step' in its processes. The amendment is a useful step forward. However, the amendment is also unrelated to the proposed extension of FOS' small business jurisdiction.

7.2 The AFC is of the view that there is evidence that paid agents and their clients are gaming the FOS EDR regime. The AFC considers this gaming is an issue of systemic importance to the financial services EDR regime.

7.3 Addressing the systemic risk posed by the actions of some paid agents will require a holistic approach. Necessary measures may include excluding paid agents who

continually abuse the FOS EDR regime, requiring paid agents to pay or contribute to the dispute fee where their claim is unsuccessful etc.

7.4 The AFC considers that the range of possible solutions should, as a matter of governance, be considered as a part of a separate and broader review of the role of paid agents within the FOS EDR regime. For this reason AFC recommends that Proposal 6.5 be removed from the FOS SME Consultation and its merits be fully considered in that separate consultation.

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Appendix 2

AFC MEMBER COMPANIES

Allied Credit
American Express
ANZ
Automotive Financial Services
Bank of China
Bank of Melbourne
Bank of Queensland
BMW Australia Finance
Branded Financial Services
Capital Finance Australia
Caterpillar Financial Australia
Classic Funding Group
CNH Industrial
Commonwealth Bank of Australia
Credit Corp Group
Custom Fleet
De Lage Landen
Dun & Bradstreet
Eclipx Group
Experian Asia Pacific
Finance One
FlexFleet
FlexiGroup
Genworth
HP Financial Services
Indigenous Business Australia
John Deere Financial
Komatsu Corporate Finance
Kubota Australia Finance
Latitude Financial Services
Leasewise Australia
Liberty Financial
Lombard Finance
Macquarie Equipment Rentals
Macquarie Leasing
Max Recovery Australia
McMillian Shakespeare Group
ME Bank
Mercedes-Benz Financial Services
MetroFinance
Nissan Financial Services
nlc Pty Ltd
Once Australia t/as My Buy
On Deck Capital
PACCAR Financial
Pepper Australia Pty Ltd
Qudos Bank
RABO Equipment Finance
RAC Finance
RACV Finance
Ricoh Finance
Selfco Leasing
Service Finance Corporation
Sharp Finance
St. George Bank
Suncorp
Suttons Motors
Thorn Group/Radio Rentals
TL Rentals
Toyota Financial Services
Veda
Volkswagen Financial Services
Volvo Finance
Walker Stores
Wells Fargo International
Westlawn Finance
Westpac
WEX Australia
Wingate Consumer Finance
Yamaha Finance

<u>Professional Associate Members</u>:

CHP Consulting
Clayton Utz
Credit Sense Australia
Dibbs Barker
Henry Davis York
Sofico Services
White Clarke