Australian Government

Australian Small Business and Family Enterprise Ombudsman

Inquiry into small business loans

12/12/16

ISBN 978-1-925220-85-8

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Contents

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12 December 2016

The Hon Michael McCormack MP
Minister for Small Business
House of Representatives
Parliament House
Canberra ACT 2600

Dear Minister McCormack

SMALL BUSINESS LOANS INQUIRY

In accordance with the terms of reference, I am pleased to present the report outlining the findings and recommendations of my inquiry into small business loans.

The Inquiry was conducted in accordance with the requirements set out in Division 3, of Part 3, of the *Australian Small Business and Family Enterprise Ombudsman Act 2015 (Cwlth)*. It examined a range of submissions from the Parliamentary Joint Committee inquiry into the impairment of customer loans.

We engaged with stakeholders in the banking and financial services industry, including Australia's biggest four banks. We also engaged with peak industry bodies and the original submitters to the Parliamentary Joint Committee (PJC) inquiry on corporations and financial services in relation to the impairment of customer loans. It has been a sobering process to review the experiences of business owners impacted by the poor practices of some members of the banking industry.

The report makes 15 recommendations, designed to address gaps in the existing regulatory environment and with the practices of industry participants.

In making the recommendations, I have drawn on information and documents gathered through private and public hearings, consultations and representations of parties to the Inquiry process.

In the terms of reference, you asked me to review a selection of Parliamentary Joint Committee cases. We have done so. We have also conducted a 'deep dive' on certain of these cases with the input of a panel of experts. I thank you for allowing the Inquiry team additional time to complete this review, caused by issues in obtaining necessary information. We will provide a completed case review in the near future.

Yours sincerely

Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman

Executive summary

On 6 September 2016, the Minister for Small Business, the Hon Michael McCormack MP, tasked the Australian Small Business and Family Enterprise Ombudsman with undertaking an inquiry into the adequacy of the law and practices governing financial lending to small businesses.

Consistent with other inquiries, the Ombudsman finds almost complete asymmetry of power in the relationship between banks and small business borrowers. This manifests itself in:

- extremely complex, one-sided contracts that yield maximum power to banks to make unilateral changes whenever they like and without the agreement of borrowers
- inadequate timeframes around key loan milestones that leave borrowers vulnerable
- misleading and conflicting signals between bank sales staff and credit risk staff which leaves borrowers vulnerable
- lack of transparency and potential conflict of interest in dealings with third parties involved in impaired loan processes, such as valuers, investigative accountant and receivers
- significant gaps in access to justice with nowhere to go except the court system, with borrowers having limited resources and banks having overwhelming resources.

Since the global financial crisis (GFC), 17 inquiries and reviews have been held and more than 40 recommendations made relating to small business and banking practices. Despite borrowers and stakeholders persistently raising the same issues, the banking industry has taken little action.

The Inquiry reviewed a selection of cases submitted to the Parliamentary Joint Committee Inquiry into the Impairment of Customer Loans. About a third of these cases were simply poor business decisions where the bank appears to have acted reasonably, a third a mixture of poor business decisions and poor bank practice and a third with very real issues where bank conduct is unacceptable and possibly unconscionable.

The recommendations raised in this report, which also support the initial findings of the Ramsay Review Interim Report, will address these issues going forward. For past cases, where there is a genuine concern, there needs to be a specific approach to seek a remedy which will allow these bank customers to put their case and to obtain compensation that is binding on the banks. The remedy needs to produce a capacity to come to a determination in a timely manner, without including lawyers and with a scope that is not limited to contract clauses.

Recommendations

1	The Australian Bankers' Association's six-point plan must be strengthened by publishing individual bank implementation plans, including key milestones and deliverables. Outcomes against these plans must be published. Implementation by 1 July 2017.
2	The revised Code of Banking Practice 2017 be approved and administered by the Australian Securities and Investments Commission under Regulatory Guide 183. The Code must be written in plain English and include a dedicated section on small business clarifying how breaches will be enforced. Implementation by December 2017.
3	For all loans below $5 million, where a small business has complied with loan payment requirements and has acted lawfully, the bank must not default a loan for any reason. Any conditions must be removed where banks can unilaterally: • value existing security assets during the life of the loan • invoke financial covenants or catch-all 'material adverse change' clauses. Implementation by 1 July 2017.
4	A minimum 30-business day notice period to all changes to general restriction clauses and covenants (except for fraud and criminal actions) be added to give borrowers more time to respond and react to a potential breach of conditions. Implementation by 1 July 2017.
5	For loans below $5 million, banks must provide borrowers with decisions on roll over at least 90 business days before loans mature, so borrowers can organise alternative financing. A longer period of time should be given for rural properties and complex businesses that would take longer to sell or refinance. Implementation by 1 July 2017.
6	For loans below $5 million, banks must provide a one-page summary of the clauses and covenants that may trigger default or other detrimental outcomes for borrowers. Implementation by 1 July 2017.
7	For loans below $5 million, banks must put in place a new small business standard form contract that is short and written in plain English. Implementation by December 2017.
8	All banks must provide borrowers with a choice of valuer, a full copy of the instructions given to the valuer and a full copy of the valuation report. Implementation by 1 March 2017.
9	Every borrower must receive an identical copy of the instructions given to the investigating accountant by the bank and the final report provided by the investigative accountant to the bank. Implementation by 1 July 2017.
10	Banks must implement procedures to reduce the perceived conflict of interest of investigating accountants subsequently appointed as receivers. This can be achieved through a competitive process to source potential receivers and by instigating a policy of not appointing a receiver who has been the investigating accountant to the business.
11	The banking industry must fund an external dispute resolution one-stop-shop with a dedicated small business unit that has appropriate expertise to resolve disputes relating to a credit facility limit of up to $5 million.

12	Banks must establish a customer advocate to consider small business complaints and disputes that may or may not have been subject to internal dispute resolution.
13	External dispute resolution schemes must be expanded to include disputes with third parties that have been appointed by the bank, such as valuers, investigating accountants and receivers, and to borrowers who have previously undertaken farm debt mediation.
14	A nationally consistent approach to farm debt mediation must be introduced.
15	The Australian Securities and Investments Commission must establish a Small Business Commissioner.

Under the *Australian Small Business and Family Enterprise Act 2015*, Section 64, the Ombudsman may take steps to promote best practice for entities dealing with small business.

Accordingly, the Ombudsman will work with the banks:

- and the Australian Bankers' Association (ABA) to add a small business section to the Code of Banking Practice, which includes amendments as recommended in this report
- to monitor implementation of the recommendations of this report and publish a six-monthly status update
- to receive and publish statistics provided by the banks on non-monetary defaults and recovery actions
- to receive data from customer advocates on issues raised, considered, resolved and transferred to external dispute resolution (EDR).

The Ombudsman will also work with the Australian Securities and Investments Commission (ASIC) to:

- review the response of banks to meeting the unfair contract term legislation
- consider the revised Code of Banking Practice for approval under Regulatory Guide 183
- establish an ASIC Small Business Commissioner.

1. Introduction

1.1 Referral of Inquiry

On 6 September 2016, the Minister for Small Business, the Hon Michael McCormack MP, tasked the Australian Small Business and Family Enterprise Ombudsman (the Ombudsman) with undertaking an inquiry into the adequacy of the law and practices governing financial lending to small businesses. The Inquiry was required to examine cases investigated by the Parliamentary Joint Committee (PJC) on corporations and financial services in its *Impairment of Customer Loans* report and provide advice to the Australian Government on deficiencies around the regulation and practices of banks.

1.2 Terms of reference

The Minister has stated that the Ombudsman, in undertaking the Inquiry, should:

- review a selection of the cases identified by the PJC as unfair and determine if there are deficiencies in the regulation of authorised deposit-taking institutions in lending to small business
- refer matters identified to the relevant authority for further consideration
- determine if the regulatory deficiencies identified by the PJC, or additional deficiencies identified through the Inquiry, are being addressed by Government and industry reforms
- recommend if additional reform measures should be implemented (legislation, regulations, guidance and practices) so products perform the way they should, considering that consumers are responsible for their financial decisions, including market losses, when they have been treated fairly, and considering the impact on the availability and cost of credit to small business.

The Minister also required the Ombudsman to provide interim findings relevant to the independent Ramsay Review[1] of the financial system's EDR and complaints framework within six to eight weeks. The interim report was submitted to the Ramsay Review on 9 November 2016.

The Minister required the Ombudsman to deliver the final Inquiry report in 12 weeks, at the end of November 2016. Due to delays in gathering information, the Minister granted an extension to 12 December 2016.

The signed terms of reference for the Inquiry are in Appendix A.

[1] Led by Professor Ian Ramsay: https://consult.treasury.gov.au/financial-system-division/dispute-resolution/

1.3 Australian Small Business and Family Enterprise Act and powers

The Ombudsman's activities and powers are governed by the *Australian Small Business and Family Enterprise Act 2015 (Cwlth)* (the Act).

Under Division 3, Part 3, of the Act, the Minister referred the Inquiry to the Ombudsman who has certain powers to conduct the Inquiry. The Ombudsman can:

a) by notice, require a person to provide information and documents relevant to the Inquiry
b) by notice, summons a person to appear at a hearing to give evidence
c) hold private and public hearings.

Documents produced for, or given to, the Ombudsman will be made available to the public under Section 53 of the Act. However, the Ombudsman must first delete confidential information. The evidence or matters in documents given to the Ombudsman during a private hearing may be restricted from being published under Section 52.

Where the Ombudsman directs that a hearing take place in private, the Ombudsman may give directions prohibiting or restricting the publication of evidence given before a hearing or matters in documents relating to a hearing.

Details on the conduct of the Inquiry are in Appendix B.

2 Previous inquiries, current reforms

2.1 Parliamentary Joint Committee findings

The PJC identified a persistent pattern of abuse of the almost complete asymmetry of power in the relationship between lenders and borrowers and considered four factors that made small business borrowers vulnerable and enabled banks to exploit this vulnerability.

These factors are:

1. there is a wide variation of conduct that lenders deem acceptable due to the significant level of discretion and commercial judgement available to banks for initial lending and managing loans in financial difficulty
2. complex, non-negotiable loan contracts, coupled with gaps in legislation and regulations, that give banks the power to behave in ways that—in relation to loans—is unethical, unreasonable and lacking in transparency
3. in many cases, borrowers in financial difficulty are unable to pursue their rights though the courts because the process is either unaffordable, or they have lost control of their financial assets due to the appointment of receivers
4. there are significant gaps in the coverage of mediation and external dispute resolution schemes leaving borrowers without the means to have their disputes with banks tested.

The PJC was acutely aware that many issues raised are not new—many had been considered by earlier Parliamentary and other inquiries.

2.2 Many inquiries but little action

David Cohen, Group Chief Risk Officer, CBA said:

> … I understand the concern around inaction over a period of time. The fact of the matter is that banks continue to appear before inquiries' where recommendations are made and things don't happen is not a satisfactory process.[2]

Since the GFC (2009 to 2016), 17 inquiries and reviews have been undertaken into practices in the financial services sector. Seven are in progress.

More than 40 recommendations have been made relating to small business and banking practices. Issues have been repeatedly raised and recommendations recycled from one inquiry into the next with the banking industry taking little action. Examples of key issues previously raised that have a negative impact on small business and have not been resolved are:

- power imbalance
- one-sided contractual relationship
- unilateral changes to contracts
- poor communication
- lack of transparency
- inadequate timeframes
- significant gaps in access to justice.

A table of previous inquiries reviewed is in Appendix C.

2.3 Inquiry survey

The Inquiry sought to understand exactly what reforms banks can implement now. An Inquiry survey was conducted with all 25 members of the ABA. The four major banks and another six banks responded.

The four major banks have the majority of small business customers and as leaders will be the exemplar for change in the industry.

[2] David Cohen, Group Chief Risk Officer, CBA, Transcript of public hearings, 30 November 2016, p. 10.

The responses from the four major banks are throughout the report and give an indication of the impetus to adopt reforms. It is clear that Westpac and ANZ are more progressive in their attitudes to reform. A copy of the complete Inquiry survey is in Appendix D.

2.4 Current industry and government reform

Recommendation 1:

The Australian Bankers' Association's six-point plan must be strengthened by publishing individual bank implementation plans, including key milestones and deliverables. Outcomes against these plans must be published.

Implementation by 1 July 2017.

Current state

It is unclear what will happen with the ABA's six-point plan and if delivery of meaningful reform will be achieved.

Recommended changes

Follow-up with the commitment of the ABA's Chief Executive Officer (CEO) to publish its intent, implementation strategy and the outcomes of the six-point plan.

Rationale

- To achieve the ABA's stated aim, setting out the banks' commitment on implementation and publicly measuring delivery.

Implications for banks

Restoring the trust of the community that its concerns have been addressed.

Implications for borrowers

Increased confidence from knowing that the banks have taken meaningful action.

In April 2016[3], the ABA announced its six-point plan to address many problems raised and test the banking industry's commitment to implement reform measures.

The plan contains measures designed to protect consumer interests, increase transparency and accountability, and build trust and confidence in banks. The ABA appointed former Commonwealth Auditor-General, Ian McPhee, to independently report on the industry's progress in reforming itself.

The details on the ABA six-point plan are in Appendix E.

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[3] http://www.bankers.asn.au/media/media-releases/media-release-2016/banks-act-to-strengthen-community-trust

Two key independent industry reviews are being conducted in conjunction with the six-point plan. These are reviews of:

- the Code of Banking Practice, being conducted by Phil Khoury, Managing Director, Cameron Ralph (due December 2016)
- product sales commissions and product sales payments, being conducted by Stephen Sedgwick AO, former Australian Public Service Commissioner (due 31 March 2017).

Government inquiries relevant to reforms in the six-point plan include:

- External Dispute Resolution and Complaints Framework—led by Professor Ian Ramsay, who released an interim report on 6 December 2016. The final report is due in March 2017.

- Review of the Financial Ombudsman Scheme (FOS) jurisdiction—the FOS, in conjunction with the ASIC, is reviewing its small business jurisdiction.[4] For small businesses with financial services disputes, the FOS is a key way to access justice. This will align with the outcomes of the Ramsay Review in March 2017.

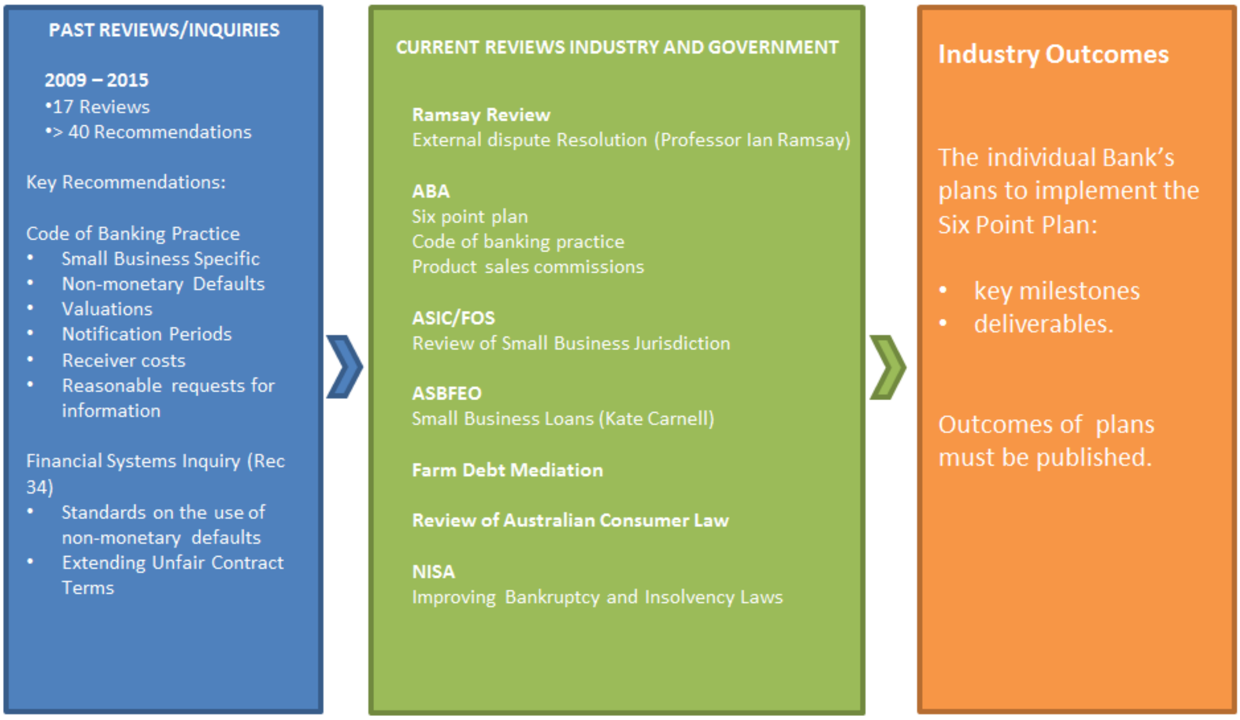
- Review of Farm Debt Mediation (FDM)—the Minister for Agriculture, the Hon Barnaby Joyce MP, announced at the Agricultural Finance Forum meeting on 23 September 2014 that he would establish a working group to investigate options for a nationally consistent approach to FDM. A due date has not been announced.

- Review of the Australian Consumer Law—Consumer Affairs Australia and New Zealand is reviewing consumer law, including protections under this law available to small business. This review is considering the effectiveness of current laws and their administration, and if they are sufficiently flexible to address new and emerging issues. The final report is due March 2017.[5]

- Improved Bankruptcy and Insolvency Laws—as part of the National Innovation and Science Agenda (NISA), a proposals paper was released on measures to improve Australia's bankruptcy and insolvency laws, introducing a safe harbour for directors, and changing the operation of *ipso facto* clauses.

[4] https://www.fos.org.au/small-business/our-small-business-jurisdiction/
[5] http://consumerlaw.gov.au/review-of-the-australian-consumer-law/about-the-review/

Figure 1: Progress from past inquiries



2.5 Review of Australia's four major banks

The Australian Government Treasurer asked the House of Representatives Standing Committee on Economics (the Committee) to conduct a review into and report on Australia's four major banks by holding public hearings at least annually. The Committee completed its first annual review in October 2016. It reported on how individual banks and the banking industry are responding to issues previously raised in Parliamentary and other inquiries. It also reported on how banks are implementing the ABA's six-point plan to enhance consumer protections and their response to government reforms and actions by regulators.[6]

Andrew Thorburn, Managing Director and Group CEO, National Australia Bank (NAB), responded:

> As chair of the ABA, I have worked with my counterparts and we have committed to making real changes together. In April this year, following extensive consultation, we launched a comprehensive reform package of six initiatives aimed at building further trust and confidence in our banks. This package has strong oversight from independent experts holding the industry to account and reporting on progress every 90 days.[10]

To demonstrate its commitment to reform, Mr Thorburn said:

> At NAB, since 2014, our vision has been to be Australia and New Zealand's most respected bank. When you have 35,000 staff serving millions of customers, there will be mistakes

[6] Terms of Reference, House of Representatives Standing Committee on Economics, 4–6 October 2016.

> made. We must acknowledge these mistakes and we must be accountable and fix them. If we want our customers to trust us, we have to do more to build that trust.[7]

Ian Narev, Managing Director and CEO, the Commonwealth Bank of Australia (CBA), said:

> In the case of ABA initiatives, an industrywide program of work is being overseen by Ian McPhee, a former Commonwealth Auditor-General … I am confident that these changes are improving our customer experience literally every day. We are making them with determination and urgency.[8]
>
> We are taking it seriously. It is being led at the top. It is all subject to independent scrutiny. In addition to that we are active participants in a package of reforms from the ABA—again, all with independent scrutiny—and, in addition to that, we are actively engaged here with policymakers working out how to have a better banking system …[9]

Shayne Elliott, CEO, Australia and New Zealand Banking Group Limited (ANZ), said:

> Over the last few years parliament has examined aspects of our industry's behaviour. This has helped shed light on cases where my bank has failed some of our customers. I say this to acknowledge our failings and the role parliament plays in holding us to account.
>
> We are making it right for customers, fixing systems … we are working with our industry on significant improvements regarding remuneration, whistleblowing and the banking code of practice.[10]

Brian Hartzer, Managing Director and CEO, Westpac, said:

> I think I and all my management team are absolutely accountable for maintaining high standards and for not just reacting to issues but proactively looking to make sure that the business systems we put in place are designed to deliver sustainable and good outcomes for customers.[11]
>
> In recent years it is clear that a trust-gap has opened up, and we as an industry and as individual banks need to work harder to close that gap.[12]

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[7] Hansard, House of Representatives Economics Committee on Economics, 6 October 2016, p. 3.
[8] ibid.,4 October 2016, p. 3.
[9] ibid., p. 35.
[10] ibid., 5 October 2016, p. 3.
[11] ibid., 6 October 2016, p. 58.
[12] ibid., p. 38.

3. Findings and recommendations

3.1 Code of Banking Practice

Recommendation 2: The revised Code of Banking Practice 2017 be approved and administered by the Australian Securities and Investment Commission under Regulatory Guide 183. The Code must be written in plain English and include a dedicated section on small business clarifying how breaches will be enforced.

Implementation by December 2017.

Current state

The Code is self-regulated. It is written in legal terms from the banks' perspective with small business mixed-in with consumers.

Recommended changes

- Gain approval under ASIC Regulatory Guide 183.
- Provide a dedicated small business section.
- Simplify the language.
- Remove caveats that enable bank discretion to decide not to adhere to clauses.

Rationale

- To achieve its stated aim, the Code must set out the banks' obligations to customers, provide benefits to customers and be understood by customers.
- To recognise in practice that small businesses bank differently to consumers.

Implications for banks

- Restoring the trust of the community and confidence by the community that it can understand the Code.
- Providing a tool to assist the banks to be certain that all customers understand the obligations of products offered.

Implications for customers

- Increased confidence from knowing what banks can and cannot do.
- A tool provided that customers can use to start a conversation with their bank when they have a complaint or dispute

Results of Inquiry survey

	Four major banks	
	Y (%)	N (%)
1. CODE OF BANKING PRACTICE—POSSIBLE REFORMS		
Rewrite in plain English.	**100**	**0**
Submit revised Code to ASIC for approval under Regulation 183.	**100**	**0**
Separate the small business section rather than dispersing small business throughout the Code.	**75**	**25**
Include standards on reform measures, such as on timelines for roll over and unilateral changes, use of non-monetary covenants, valuations, internal dispute resolution (IDR) and EDR.	**100**	**0**

The current review of the Code provides the opportunity for banks to develop the Code to the highest standards. To ensure the Code achieves its purpose in providing greater small business protections, it needs to be reinforced with ASIC approval.

Change is overdue and the banks are on notice. The preferred outcome would be that banks lead the way by driving change through self-regulation and delivering change quickly with meaningful outcomes. There is no reason why an amended Code of Banking Practice could not be achieved by 1 July 2017.

If banks fail to deliver on this themselves, other options are available. They are, however, slower and more costly as they would require Government intervention, such as implementing a mandatory code or legislative change.

The pathway to change is outlined in Figure 2 Pathway to change

	Pathway to change	Description	Key considerations
Driven by the banks	**Voluntary change by the banks**	• The banks remove NMD clauses in standard form contract for under $5m • Banks adhere to realistic mandated timeframes	• The least confrontational approach – requires voluntary action from the banks, ideally led by a first-mover • Positive publicity for both the banks and the government; Ombudsman can give positive public feedback
	Amend Code of Banking Practice	• A revised Code of Banking Practice is in effect by June 2017 • The revised Code is approved by ASIC	• Requires banks' consensus and may lead to stalling • Recent NAB[1] and CBA[2] rulings set precedent– Code can be used to sue the banks
If not achieved			
Driven by the Government	**Mandatory Code of Conduct**	• The code for banking is mandatory • ASIC enforce the mandatory code	• Will require the support of a MP or the Government and be voted for in Parliament • Need to balance prescriptiveness of the regulation and not overly influencing the banks' ability to lend
	National Credit Code	• Change made to the National Consumer Credit Protection Act 2009 which enforce the recommendations of this Inquiry	• Will require the support of a MP or the Government and be voted for in Parliament • Need to balance prescriptiveness of the regulation and not overly influencing the banks' ability to lend

The 2012 Economics References Committee into the banking sector post-GFC noted:

Failure by the ABA and the banks to develop an appropriate code of conduct for small business lending may strengthen the case for more prescriptive government regulation in this area. Given the arguments from the sector about the cost and burden of added regulation in general, the committee is of the view that if banks genuinely have these concerns they have both the obligation and opportunity to demonstrate that the sector takes concerns about small business finance issues seriously and is willing to proactively develop a stronger self-regulated solution.[13]

Australian Bankers' Association Code of Banking Practice

The ABA developed the Code of Banking Practice. It began in 1993.[14] The Code was developed in response to consumer dissatisfaction with banks and was, in part, intended to forestall proposals that the Australian Government introduce statutory consumer protections for the banker-consumer relationship. Originally, it only applied to the supply of banking services to individuals (with the addition of taking guarantees from individuals).

Following a review by Richard Viney in 2000–01[15], the Code was substantially amended in 2003. Among other changes, this version of the Code extended most of its provisions to small business customers, using the definition in Chapter 7 of the *Corporations Act 2001 (Cwlth)*.[16] The recommended approach was to treat small business customers in essentially the same way as consumer customers with some exceptions such as confidentiality and privacy and access to low-cost accounts.

Protections for guarantors did not extend to small businesses that gave guarantees. Some protections for individual guarantors did not apply where the individual had guaranteed loans to small businesses. The small business provisions in the Code replaced the ABA's Banks and Small Business Working Together—A Set of Principles. The 2003 Code also introduced the Code Compliance Monitoring Committee (CCMC). The Code was amended again in 2004 which further prescribed the role of the CCMC.

A substantial independent review of the Code was then undertaken by Jan MacClelland in 2007–08. This resulted in the 2013 Code. The ABA and its members did not accept some recommendations of the MacClelland Review.[17] For example, MacClelland recommended that the

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13 http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Completed_inquiries/2010-13/postGFCbanking/report/index, p. xxiv.

14 For previous versions of the Code: http://www.bankers.asn.au/industry-standards/abas-code-of-banking-practice/code-of-banking-practice

15 Review of the Code of Banking Practice, Final Report, Richard Viney, October 2011, http://www.reviewbankcode.com/pdfs/FinalReport.pdf

16 In the 2003 Code, small business was defined to be a business with
(a)less than 100 full-time (or equivalent) people if the business is or includes the manufacture of goods; or
(b)in any other case, less than 20 full-time (or equivalent) people, unless the banking service is provided for use in connection with a business that does not meet the elements in (a) or (b) above.

17 http://www.ccmc.org.au/2011/11/06/review-of-the-code-of-banking-practice-2007-08/

Code impose a general responsible lending obligation on banks when lending to consumers and small business customers with these terms:

> We will be responsible lenders in approving credit, offering credit limit increases, supporting customers facing financial difficulty; and promoting responsible use of credit.[18]

The ABA noted that the Australian Government was considering national credit legislation with a responsible lending component and instead proposed that the revised Code of Banking Practice simply state that:

> To the extent applicable, we will comply with all relevant laws and this Code relating to responsible lending.[19]

The ABA sought to introduce consistency between the Code and the new legislation and argued that the Code should not impose obligations going beyond the legislation. In the event, the ABA successfully lobbied to have the *National Consumer Credit Protection Act 2009 (Cwlth)* restricted to consumer credit for personal and domestic purposes and hence that Act, including its responsible lending obligations, did not apply to small business lending.

MacClelland also recommended that provisions for managing financial hardship claims be included in the Code. The ABA accepted many of these and rejected others. One rejected provision was:

> While we are considering your application for assistance where you are experiencing financial difficulty in relation to a credit facility with us, we will not commence any enforcement action in relation to the debt or assign the debt. If we reject your application for assistance, we will allow you a reasonable period of time to obtain advice, before we commence enforcement action in relation to the debt or assign the debt. If we have commenced enforcement action before you made the request, we will not proceed to judgment whilst we are considering your situation.[19]

Instead the Code says that member banks will comply with the National Credit Code hardship provisions where they apply. There are some limits in Section 89A of the National Credit Code on enforcing loans under the Code while the current hardship notice is being considered and for 14 days after a lender's decision not to change the contract on the basis of the hardship notice. As noted earlier, those provisions do not apply to small business loans.

Revisions require subscribers to be proactive in managing hardship. They enhance the system of dispute resolution and monitoring and sanctioning for breaches of the Code and, for small business, introduce a 10-day notification period for unilateral variations that may be materially adverse to customers.

Recent recommendations relating to the Code are in Appendix F.

Case study on international best practice

The Inquiry reviewed international banking practices. Of note was the progression in Ireland from:

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[18] Final report on the Review of the Code of Banking Practice 2007-2008, 11 December 2008, p. 12

[19] Review of the Code of Banking Practice by ABA to Review Final Recommendations, September 2009

- a voluntary Code of Conduct to a regulated Small and Medium Enterprise (SME) code in 2009
- to a revised SME Code in 2012
- to regulation under the Central Bank (Supervision and Enforcement) Act 2013, Section 48, and Lending to Small and Medium-Sized Enterprises Regulations 2015, to take effect from July 2016.

The regulations further categorise businesses between micro and small and medium. These categories are defined by number of employees, turnover and annual balance sheet total. Detailed protections are regulated for micro and small businesses. High-level protections are regulated for medium-sized businesses.

The key issues that drove Ireland's move from a voluntary code to regulation are like those facing Australia's financial system today. These include the need for:

- better communication from lenders regarding timelines
- clarity from the start about the credit application process
- transparency on how ability to repay is determined
- reliance on personal guarantees
- sufficient information on declined applications
- SMEs to be more aware of their right to appeal.

Approval under the Australian Securities and Investment Commission's Regulatory Guide 183

ASIC approval of the Code will improve its transparency and enforcement. It will also improve community knowledge of the Code's provisions and protections. As Graham Hodges, Deputy Chief Executive, ANZ, said:

> Now, I think the banks have done that okay in some areas, and probably not well enough in others. So, you know, I would be the first to say, this code has needed an upgrade and I think is being strengthened. Whether it now morphs into ASIC supervising it, we are actually comfortable with that. And I think the issue that we're saying is, let's make sure it's clear what the roles and responsibilities are around the various parties in that. That's what we would ask for.[20]

Under Section 1101A, Corporations Act, ASIC has the discretion to approve codes of conduct relating to financial services providers. In 2013, ASIC released its regulatory guide for the approval of the financial services sector's codes of conduct (Regulation 183).

ASIC expects an effective code to:

(a) address specific industry issues and consumer problems not covered by legislation

(b) elaborate on legislation to deliver additional benefits to consumers

[20] Graham Hodges, Deputy Chief Executive, ANZ, Transcript of public hearings, 29 November 2016, p. 58.

> (c) clarify what is needed from the perspective of a particular industry, practice or product to comply with legislation.[21]

The key criteria for a Code approval, according to Regulation 183.12, are to:

- be freestanding and in plain language
- have a 'body of rules'
- have a consultative process for development
- meet statutory criteria for code approval
- address stakeholder issues
- have effective and independent code administration
- be enforceable
- have appropriate remedies and sanctions
- be promoted
- be reviewed every three years.

Banks have expressed concern that code approval may result in EDRs overlapping and create more regulatory burden. While ASIC requires a code to be administered by an independent body, with the power to enforce sanctions, it does not expect that body to replace EDRs.

> Regulation 183.25 (c) the code provisions provide that consumers have access to internal dispute resolution (IDR) processes and an appropriate external dispute resolution (EDR) scheme for any code breaches resulting in direct financial loss.[22]

No teeth

ASIC considers, from a consumer's perspective, that 'the ability to pursue a complaint about a breach of a code is an important test of how effective that code is.'[23]

Significant change is required for the Code to be seen to provide protections for customers that banks will be held accountable for. The first step is to add performance standards that can be measured. The second step is to for an independent body to enforce the Code. The third step is for banks to commit to quickly effect remedies determined by the independent body. The final step is to gain approval under ASIC Regulatory Guide 183.

For the Code of Banking Practice to be effective, it must contain substantive provisions and be monitored and enforced. Although monitored by the CCMC, many feel the Code has 'no teeth'. For example, while a customer can raise a complaint with the CCMC, they cannot receive compensation or remediation. The CCMC can seek an undertaking from a subscriber to improve its banking practice, monitor its progress in doing so and name, in its annual report, subscribers that breach the Code. However, the CCMC has only ever named one bank in an annual report (in 2007–08).

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[21] ASIC, Regulatory Guide 183, p. 5.
[22] ibid., p. 16.
[23] Ibid., p.16.

The CCMC's website quotes that:

> In our first year of operation (2004), banks self-reported 195 breaches of the Code. More than ten years on—in 2014–15—banks self-reported over 6,500 breaches. In 2014–15, banks self-reported 16 significant breaches, affecting more than 150,000 customers and with a financial impact of nearly $13 million. Issues with IT [information technology] systems caused a number of these breaches.

This data does not identify the number of small businesses affected by the breaches

Written from the perspective of the bank

The current review of the Code must change the Code's focus from protecting banks to protecting customers of banks. The Code must be written in a way that a customer can understand, what to expect from their bank and what their rights are when banks fail to meet their obligations

The Australian Competition and Consumer Commission (ACCC) guidelines for developing an effective code states:

> Effective codes potentially deliver increased consumer protection and reduced regulatory burdens for business. To achieve this they must be well designed, effectively implemented and properly enforced.[24]

The Ombudsman challenged bank executives on how the Code increases consumer protection. The Ombudsman sought Westpac's view of clause 20.4 (b) reading:

> …we will give you a reasonable period of time, not less than 10 days currently in writing, of that variation unless we consider a shorter period of time is necessary for us to avoid or reduce an increase in credit risk to us.

David Lindberg, Chief Executive, Business Bank, Westpac, responded:

> Well, let me try to be as clear as I can, because I'm quite passionate on this topic. The code as written is not clear enough. The code as written is not good enough. We've asked for the code to be rewritten independently. We're seeing that come to us at the end of December. [25]

Dedicated section for small business

The Inquiry recommends that the Code includes a dedicated section for small business to cover off on its special needs. Currently, the Code mixes small business with consumers, yet there are distinct differences between the two groups.

Treating 'small businesses' like 'consumers' fails to recognise these key differences:

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[24] ACCC, Guidelines for developing effective voluntary industry codes of conduct, p. 1.
[25] Transcript of public hearings, Westpac, 29 November 2016, p. 23.

- the daily transactions of small business are far more complex than are the daily transactions of consumers
- the size of the financial commitments of small business often significantly exceeds those of consumers
- small business owners may have less time to seek assistance with legal issues or problems than consumers.

The special position of small business borrowers was recognised by the PJC. Adam Bennett, Group Executive, Business and Private Banking, the CBA, said:

> Many [borrowers], however, are small family businesses—who may still have to borrow millions of dollars to achieve their commercial objectives—yet be run by an individual, family or partnership that has significant personal exposure due to the use of personal assets such as the family home as security.[26]

3.2 Contract terms and conditions

Recommendation 3: For all loans below $5 million, where a small business has complied with the loan payments requirements and has acted lawfully, the bank must not default a loan for any reason. Any conditions must be removed where banks can unilaterally:

- **value existing security assets during the life of a loan**
- **invoke financial covenants or catch-all 'material adverse change' clauses.**

Implementation by 1 July 2017

Current state

Property valuation, financial ratios and generalised 'material adverse change' clauses are present in small business loan contracts. Some banks support removing them from all loans below $1 million.

Recommended change

For all loans below $ 5 million, remove these two conditions that grant banks to unilaterally invoke:

- security asset valuation during the life of a loan (asset valuation is appropriate at loan inception and the roll over date)
- financial covenants and catch-all 'material adverse change' clauses.

Rationale

- To ensure banks do not have unilateral power to invoke loan default.
- To rebalance risk distribution between borrowers and banks—currently, loan conditions transfer most risks to borrowers, protecting banks.
- To simplify contract construct, especially for small business loans.
- Banks claim that more than 98 per cent of lending to small business customers is under $5 million.

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[26] PJC on the Impairment of Customer Loans, p. ix.

Implications for banks

- Removing unilateral power clauses creates some additional risks for banks, which banks may claim have an impact on loan pricing, however there is high-level evidence that these conditions are rarely triggered; suggesting that no price increase is required.
- Standardising and simplifying contract terms may create easier distribution of business loans with digital and remote channels and reduce loan origination costs for banks.
- Reducing complexity of contracts will result in less legal work, saving banks money.

Implications for borrowers

- Reducing or eliminating instances when banks unilaterally trigger non-monetary default clauses.
- Reducing complexity of loan contracts, which makes them easier to understand.

Recommendation 4: A minimum 30-business day notice period to all changes to general restriction clauses and covenants (except for fraud and criminal actions) be added to give borrowers more time to respond and react to a potential breach of conditions.

Implementation by 1 July 2017.

Current state

Notice periods prescribed in clauses and covenants included in small business loan contracts can be disregarded by banks.

Recommended change

Add a 30-business day notice period to all general restriction clauses and covenants (except for fraud and criminal conditions). This would include, for example, general clauses like not changing a company's ownership structure.

Rationale

- To give borrowers more time to respond and react to a breach of conditions, reducing the chance of a business in good financial standing being subject to a loan default.

Implications for banks

- Delaying ability to intervene, increasing the risk for the bank.
- Enabling banks to avoid a price increase for handling potential risk given that general clauses and covenants are currently not explicitly priced in contracts.

Implications for borrowers

- Providing borrowers with greater flexibility for borrowers to comply with loan conditions, and possibly avoid loan default and foreclosure.

Recommendation 5: For loans below $5 million, banks must provide borrowers with decisions on roll over at least 90 business days before loans mature, so borrowers can organise alternative financing. A longer period of time should be given for rural properties and complex businesses that would take longer to sell or refinance.

Implementation by 1 July 2017.

Current state

No mandatory advance notice to small business of loan roll over decisions exists.

Recommended changes

For loans below $5 million, banks must provide borrowers with decisions on roll over at least 90 business days before loans expire:

- Where material events are anticipated in the 90-day period, banks are entitled to offer conditional refinancing.
- Banks retain the right to decline renewal where borrowers fail to provide timely documentation required for credit assessment.
- A longer period of time should be given to rural properties and complex businesses that would take longer to sell or refinance.

Rationale

- To provide greater visibility of loan roll over decisions, allowing borrowers to organise alternative financing should roll over be refused.
- To avoid the substantial financial distress suffered by small business when roll overs are refused, especially when the decision is not expected.
- To require banks to commit to lending decisions ahead of loan maturity, which comes at a relatively low liquidity cost for banks.

Implications for banks

- Anticipating roll over decisions needed, inputting capital and funding availability calculations into the decisions.
- Avoiding additional risk provided that banks effectively communicate to small business any material changes in the 90-day period.

Implications for borrowers

- Providing greater certainty on roll over decisions in advance of roll over dates.
- Providing borrowers with greater flexibility to organise alternative finance if the roll over is denied.

Recommendation 6: For loans below $5 million, banks must provide a one-page summary of the clauses and covenants that may trigger default or other detrimental outcomes for borrowers.

Implementation by 1 July 2017.

Current state

A contract, which includes schedules, general and specific terms and conditions and the Code, are voluminous and legalistic. It is not reasonable to expect a borrower to read and comprehend each and every term in each of these documents.

Recommended change

- Banks develop a short summary of the clauses and covenants that made trigger a default.
- Banks include in the two-page summary what action the bank may take and what action the borrower may have to take if default is triggered.

Rationale

- To ensure borrowers understand what they are signing up for.
- To ensure borrowers are clear on their obligations and, when not met, what actions the bank may take.
- Banks claim that more than 98 per cent of lending to small business customers is under $5 million.

Implications for banks

- Increasing confidence that borrowers are signing up to products they understand.
- Providing a tool to fully inform front-line staff of bank policies in managing borrower performance against covenants and actions when in default.

Implications for borrowers

- Providing a clear understanding of what borrowers may need to do if they cannot meet their obligations.
- Providing a tool to help borrowers understand what they are signing up for and what actions a bank may take.

Recommendation 7: For loans below $5 million, banks must put in place a new small business standard form contract that is short and in plain English.

Implementation by December 2017.

Current state

Commercial contracts are the same for a small business borrowing up to $5 million as they are for large corporate business borrowing $100 million. The risks are not**.**

Recommended change

For small business borrowing less than $5 million, banks develop a short, plain English, standard form contract that meets the intent of the unfair contract terms legislation.

Rationale

- To simplify lending to small business, given that banks claim they do not rely on many of the clauses in existing contracts.
- To enable banks to better manage small business lending through building and maintaining strong working relationships.
- Banks claim that more than 98 per cent of lending to small business customers is under $5 million.

Implications for banks

- Ensuring contracts reflect the way banks work with small business customers.
- Increasing trust of small businesses seeking funding from banks (borrowers will understand the basis of that funding).
- Reducing complexity in loan contracts.

Implications for borrowers

- Confidence in the basis of lending as the contract only contains clauses considered to be necessary to monitor a loan.
- Confidence to enter a relationship with a bank as the basis of that relationship is transparent.

Results of Inquiry survey

	Four major banks	
	Y (%)	**N (%)**
2. LOAN CONTRACTS—POSSIBLE REFORMS		
Non-financial covenants in contracts for loans		
Remove from all contracts	**25**	**75**
Remove from contracts ≤ $1 million	**25**	**75**
Agree standards for industry for contracts $1 million to $3 million	**75**	**25**
Agree standards for industry for contracts $1 million to $5 million	**25**	**75**
Agree standards for industry for contracts $1 million to $10 million	**25**	**75**
Transparency		
Provide a two-page summary of key covenants and potential consequences to borrower	**50**	**50**
Agree industry standard summary to use	**50**	**50**

Non-monetary default clauses and covenants in loans contracts allow banks to trigger the default of a business loan where risk factors may have changed, even when the borrower has continued to meet their regular payments against the loan.

Banks use these clauses to limit their risk, but often confer broad and unilateral power to recoup funds lent or vary loan terms and conditions, including pricing (interest rate). At the same time, banks take predictable risks into account when they set initial loan prices.

Non-monetary default and related clauses are perceived as appropriate in cases of fraud, and for more sophisticated and larger business borrowers. Still, there is some evidence that banks, in some circumstances, may have used these clauses undesirably. Moreover, these clauses contribute to contract complexity.

A standard business loan contract contains many conditions—some of which banks can unilaterally trigger.

Figure 3 Standard business loan contract conditions

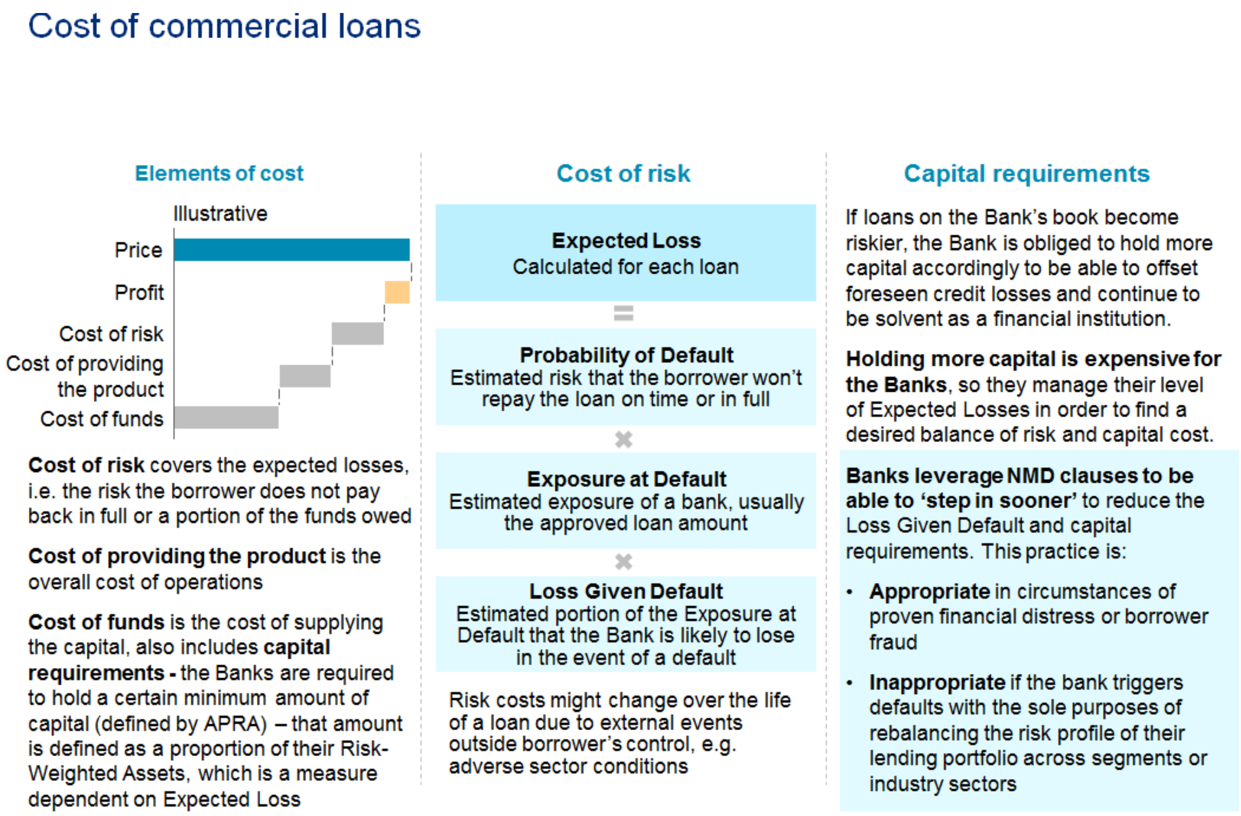
Type	**Condition** (to be upheld by borrower)	Assessment of fairness
Fraud-related	Providing false information or withholding information	• No expected detrimental impact on businesses not exhibiting fraudulent behavior
	Using the facility for other purposes than agreed	
	Criminal offenses	
General obligations	Paying taxes	• Reasonable to require from the customer and does not depend on external factors • Breaching one of those conditions does not necessarily threaten a borrower's ability to repay a loan in the short term
	Not changing the ownership structure of the company	
	Not taking other loans above a pre-agreed amount	
	Providing financial statements in a reasonable timeframe	
	Keeping proper records	
	Financial restrictions (for example, not paying dividends without the lender's consent)	
	Collateral security must be properly insured	
Conditions that banks can unilaterally invoke	Changes to collateral security value after loan inception (loan-to-valuation ratio)	• These conditions transfer most of unknown external risks to the customer • Breaching one of those conditions does not necessarily threaten borrower's ability to repay a loan in the short term
	Financial covenants (for example, interest cover ratio)	
	Catch-call 'material adverse change' conditions	

Note: Breaching each condition may lead to different consequences, such as a penalty, review of the business or default.

If the loans on a bank's book become riskier, the bank is obliged to hold more capital so it can offset foreseen credit losses. This is expensive for banks, so they manage levels of expected losses to find a desired balance of risk and capital cost.

International management consulting firm, Oliver Wyman, has presented these costs of commercial loans (Figure 4).

Figure 4: Cost of commercial loans



Banks leverage non-monetary default clauses so they can 'step in sooner' to reduce the loss given default and capital requirements. This practice is:

- appropriate when financial distress or borrower fraud is proven
- inappropriate when banks triggers defaults solely to rebalance the risk profile of their lending portfolio across segments or industry sectors, including; credit managers who want this ability to cover all risks they have not predicted and/or included in loan price.

The success of the costing model used by banks is evident in the low number of loans, as a percentage of whole loan books that move from default to impaired. The statistics provided by the ABA in its PJC submission indicate this:

> For the year ending March 2015 less than 1 per cent of business and agribusiness customers had impaired loans and a tenth of 1 per cent were in recovery action. In only a handful of cases were substantial changes to LVRs [loan-to-valuation ratios] the major factor that created impairment of the loan. The overwhelming majority of defaults were a result of monetary breaches of the loan covenant or a combination of both monetary and non-monetary breaches.[27]

Consequently, if the recommendations are adopted, the Inquiry considers that there is no justification for the banks to increase the costs of commercial loans up to $5 million.

[27] PJC on Corporations and Financial Services—Impairment of Customer Loans Report, Submission 47, p. 5.

Unilateral changes

The Inquiry recognises that it is vital for banks to manage risk but does not consider it appropriate for banks to have the means to transfer this risk to the borrower. This is not a fair balance of power.

'The important issue here is to manage risk, not avoid risk.' Ombudsman[28]

As it stands, a bank can take enforcement action against a small business, its directors and its guarantors in the way that best enables the bank recover its money quickly.

The Ombudsman highlighted the fact with CBA noting:

> But things like the loan documentation, as you know, defines all the securities, including things like director's guarantees—which I always find really interesting—as primary securities. So from the moment— that sort of enables the bank to demand full repayment of a loan from a director on the day you call it … So you could send a director into bankruptcy before you even started to sell the securities ... You can do anything, really.
>
> David Cohen, Group Chief Risk Officer, the CBA has said:
>
> And you are correct. – in an enforcement situation or a default situation that hasn't been remedied, the rights of the bank to recover its funds … in the sense that at that point the power imbalance is weighted in favour of the bank. There's no doubt about that. And that's for partly a prudential reason, because banks have to recover the money of their depositors, part, therefore, a risk management reason, to ensure that that loss that the bank might face is minimised.[29]

The PJC heard evidence that:

> … many accounts of extreme financial hardship arising from loan contracts that require the borrower to bear all the risk. The power in the contracts is so skewed in favour of banks that the capacity of a borrower to protect their rights is very limited.[30]

The PJC formed the view loan contracts result in a power imbalance between banks and borrowers.[31] This imbalance exists from the offer of finance, throughout the life of the loan and at contract expiry. This needs to be simplified, according to the Ombudsman:

> We are lending you money today … [we can] call a loan at any time for any reason … If you do not repay it immediately, we will take all of your secured property, your personal property, including your home, from you and bankrupt you under the director's guarantee. Sign here. Because that's fundamentally what the contract says.[32]

In response to the imbalance in power regarding risk, David Cohen, the CBA, said:

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[28] Transcript of public hearings, ANZ, p. 11.
[29] ibid., CBA, Bank, p. 21.
[30] PJC on Corporations and Financial Services—Impairment of Customer Loans Report, p. 59.
[31] ibid., p. 31.
[32] Ombudsman, Transcript of public hearings, 30 November 2016, CBA, p. 21.

> And if they don't—and I suppose, yes, if we step back and look at—okay, is that a fair balance of power? … No. So not a fair balance of power.[33]

On offering finance, banks recommend that small businesses seek their own legal advice before signing a loan contract. Investigations by the Inquiry have revealed that the cost for small businesses to do so can be as much as $10,000, or more for complex circumstances.

Another significant cost is the time involved for business owners. Rarely do small businesses realise their legal advice investment because banks do not negotiate on clauses that shield small business from risk. So it is not necessarily worth it for small business to invest time and money in seeking legal advice. They face the same choice from banks—take it or leave it.

Banks must remove clauses in loan contracts that allow them to change without notifying customers. Where a clause does mandate a period of notice, words that allow banks to ignore the period at their discretion should be removed.

In some circumstances, the Inquiry and community depend on banks taking immediate action. For example, to stop further criminal action by a borrower. These types of event may require immediate action by banks. However, banks need to let customers know about this by adding specific clauses around when they will take immediate action.

Non-financial covenants

The contract for a loan includes the agreement, general terms and conditions, specific terms and conditions, the Code and a schedule of covenants. Covenants are a group of measures allowing a bank to monitor the financial health of a business they have lent money to.

When a small business breaches a covenant, the bank will issue a default notice. As demonstrated in the cases reviewed by the Inquiry, the bank has the discretion to take action or not take action. Action can range from a conversation to a demand that the debt be reduced or repaid immediately.

In its submission to the PJC inquiry, the ABA stated that:

> It is extremely rare that a customer would be transferred to a "workout" area due to a LVR breach alone. Furthermore, banks would be very unlikely to enforce their security if there is no monetary default …[34]

During the public hearings on 29 and 30 November 2016, the Ombudsman tried to clarify when non-financial covenants are used.

Graham Hodges, ANZ, responded:

> They are used as an early warning indicator that a customer may face difficulty …They allow a bank to contact customers and review lending where a customer's financial condition is deteriorating. Without a contractual term based on financial measures the bank may not be

[33] David Cohen, Transcript of public hearings, 30 November 2016, CBA, p. 22.
[34] PJC on Corporations and Financial Services—Impairment of Customer Loans Report, Submission 47, p. 8.

> able to initiate a review or a discussion even where there's an obvious increase in risk or deteriorating in financial conditions … the business is not looking healthy and, therefore, what are the actions that the customer is proposing to take to manage the business in those events.

The Inquiry concluded that many clauses are in contracts on a 'just-in-case' basis. While banks claim not to invoke them with small business customers, it has always been recognised that they could be. Just-in-case clauses would not be required if this Inquiry's recommendations are adopted. This includes the recommendation that banks develop a small business standard form contract containing only clauses and covenants they intend to rely on to monitor and manage a loan.

Adam Bennett, the CBA, had an exchange at the public hearing over this issue[35]:

> They're not used universally in contracts. They're used very specifically in client situations where, depending on the industry that they're in or the nature of the performance of their business, there are particular risks that we're trying to monitor and mitigate.
>
> Anne Scott from the Inquiry Team responded:
>
> Alright. So coming back to the question, which is we get how the banks say they use them to have a conversation about an early warning sign, but they're still written in the contract in the way that the lawyers have put those terms that, if you chose to, you could go straight to default.
>
> Adam Bennett, the CBA: You could.

The power of attorney, for example, falls into the 'just-in-case' category. This clause is 'hidden' from customers in contracts yet the power of attorney can be invoked by a bank when a loan is considered to be in default. This power allows the bank to take legal ownership of the loan account, any related accounts and, if necessary, through a director's guarantee, the personal accounts of the director and secured assets.

The Inquiry does not accept that this type of clause is needed to protect the legitimate interest of banks in all circumstances. The Inquiry is concerned that most customers are not even aware that the clause exists. As a result, the Inquiry recommends that banks include in a one-page summary when it can invoke its rights through the power of attorney in the loan contract. It is also recommended the use of such powers be restricted and apply only, if at all, to circumstances where legal enforcement of securities has already commenced.

Too much to read

The volume of material that banks provide borrowers to read is overwhelming. This is illustrated by this PJC example:

> The submitter indicated that that his loan document was 53 pages long, and contained obligations on the borrower that included positive undertakings, negative undertakings,

[35] Transcript of public hearings, CBA, 30 November 2016, pp. 29–31.

> default conditions and standard terms. In the submitter's view, the banks have perfected loan contract documents so that is virtually impossible for a small to medium enterprise to challenge a bank in a court.[36]

Discussions with submitters to, and investigations by, the Inquiry, conclude that small business finds the amount of information provided, and the language in which it is written, overwhelming and difficult to understand. Small businesses are time poor and generally have to rely on third parties, such as accountants, for financial advice.

When asked what ANZ does to ensure small business understands what they are signing, Graham Hodges stated:

> Well, I've got a booklet which, obviously, every person who takes out a loan… small pages, but there's about 80 pages in here. And this is—this is, effectively—it looks like this because of regulation that we're required to put in here. As well as that, obviously, you've got the contract that you would go through and sign and that would, obviously, set out its clauses in plain English.[37]

Kate Gibson, Small Business Banking General Manager, ANZ, when asked about length and complexity of material, said:

> I would agree with you that at 86 pages it can be potentially daunting for someone to read all of that. That's why we do support the proposal to call out—have a very simple, short cover sheet as a key covenant for the terms of the loan.[38]

Complex language

While recognising that contracts must meet legal requirements to protect both bank and borrower, and to ensure fully informed consent, banks must provide a way for borrowers to understand their obligations over the life of loans.

The Inquiry was told that getting a loan from a bank involves an initial discussion, with the bank using high-level language introducing borrowers to the general loan's terms and conditions.

It is not until the customer agrees to finalise the loan that the bank engages its lawyers to draw up relevant documents. These often include special conditions. At this point, a small business has limited time to obtain legal advice (if it can afford it). In the interest of proceeding with the loan, the small business often simply signs the documentation.

Unfair contract terms

On 12 November 2016, *the Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015 (Cwlth)* to extend unfair contract protections to small business contracts came into effect. The business community hoped this legislation would solve many of the issues outlined in this report. The new legislation offered banks the opportunity to develop contracts that could be easily understood and negotiated by consumers and small businesses.

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[36] PJC on Corporations and Financial Services—Impairment of Customer Loans Report, p 31.
[37] Transcript of public hearings, ANZ, 29 November 2016, p. 6.
[38] Transcript of public hearing, ANZ, p. 6

Instead, it appears that the changes resulting from the opportunities presented by the new legislation have been minor. Two examples illustrate this:

- NAB's general terms and conditions—they no longer allow NAB to take any action that in NAB's opinion is necessary, but only take action that in NAB's reasonable opinion is necessary.
- Commonwealth Bank's current terms and conditions—they no longer require customers do anything the bank asks, but only anything the bank reasonably asks.

During the public hearings, the Ombudsman sought the reasoning behind changes made by Westpac, citing one such revised clause.

Ombudsman's query:

> "We don't really like those changes"; this is, remember, inside a contract that's in place—the facility will be repayable on demand by the lender … So, if you don't like the changes you've got an opportunity to say no, but we're just going to call the loan immediately … I'm not sure that that makes an unfair contract fair.
>
> David Lindberg, Westpac, responded:
>
> Well, I guess what I would say is—as it relates to conforming with the new legislation—that they absolutely conform … Having said that, I would be the first to concede that we want to make our contracts more and more simple over time … we're committed to removing them [covenants] from the contract.[39]

Australian Securities Investment Commission is reviewing the banks response to the unfair contract term legislation

ASIC has asked the four major banks to provide contracts with the clauses removed or amended as a result of the unfair contract terms legislation. ASIC will now review the retained clauses against the intent of the unfair contract terms legislation. The Ombudsman will consult with ASIC on the outcome of their review.

3.3 Communication

The review of the cases showed that poor communication and mixed or conflicting signals from different areas of the bank is a major problem.

Loan expiry

The Inquiry's review identified that periods of notice to customers on key loan events vary significantly between and within banks.

When entering into a contract, a small business normally considers the repayment schedule and expiry date to determine if they can meet the loan's terms and conditions. Given that small

[39] Transcript of public hearings, Westpac, 30 November 2016, pp. 9–12.

businesses are time poor, have limited resources and often rely on third parties for financial advice, the impact of a loan's expiry may not be fully appreciated.

Legally a bank can choose to roll over or decline to roll over a facility without providing a borrower with any notice or explanation. While the borrower has no legal right to assume a roll over, it is reasonable for them to assume that this would be the case if it has met all loan terms and conditions.

The cases reviewed by the Inquiry uncovered multiple instances where a bank gave a small business notice of a month or less that it was not going to offer a new loan. This surprised the small businesses since they were not aware that a roll over was at risk. During the public hearings, the Ombudsman acknowledged that small business should not assume loans will be rolled over. Yet a key difference from a home loan, which is generally paid back, is that a business loan is ongoing to fund expansion, refurbishment and innovation.

The Ombudsman asked banks to commit to communicate in a timely fashion when planning or contemplating not renewing or rolling over, providing business with at least three months' notice. The Ombudsman also asked banks to do the same when offering a new loan to a small business. Several banks responded, in different ways, to the idea.

David Lindberg, Westpac, said:

> Sure … It's interesting, I heard some other representatives talk about potentially a six-month—we tried that and what we often found was three months is the right time. It's better than six months, ironically, because if you send someone something at six months it's much more likely they will put it in the bin and it won't have the desired effect. You send something at three months, so 90 days, and it had a better effect.[40]

Leigh O'Neill, Executive General Manager, Business Direct and Small Business, NAB, said:

> So that's the proposal, and my view would be that any proposal that is fair for the customer and the bank absolutely should be considered, and we would be really happy to have another ongoing conversation about that, and I feel like I need to go and get some more information to find out.[41]

Graham Hodges, ANZ, said:

> We support requiring lenders to provide small business borrowers with reminder notices of at least six months prior to the expiry of their commercial loan where the customer is not in default, with at least three months' notice if a decision is made not to roll over or extend that loan and the loan is not in monetary default.[42]

[40] Transcript of public hearings, Westpac, 30 November 2016, p. 17.
[41] ibid., NAB, 29 November 2016, p. 37.
[42] ibid., ANZ, 29 November 2016, p. 4.

David Cohen, the CBA, said:

> What timeframe should that be? And yes, I think in your discussions there was discussion around a three month notice period, and giving the customer at least three months to make alternative arrangements if the bank was not going to proceed with the existing loan.[43]

Case study: Inadequate timeframes

A small business owner had a seven-year relationship with his bank and was a 'preferred customer'. He had a track record of managing loan facilities well and consistently met interest payments.

The small business owner's loan was due to expire at the end of June. As in previous years he anticipated the bank would agree to an ongoing loan facility with sufficient funds for him to complete a downsizing strategy. He planned to finalise a small residential development and sell his rural property which would repay the loan and provide surplus funds for retirement. Given the communications from his bank manager, as well as his previous loan history, the small business owner understood the bank would continue to support him.

Three months before the loan expired the bank asked for financial statements and a valuation of assets. The small business owner cooperated and kept the bank informed. The customer also requested some additional funds to expedite his planned business strategy. The bank agreed to extra funds in addition to the previous debt. The loan was highly securitised.

Despite the old loan facility expiring at the end of June, the bank did not provide the new loan documents until late August. The bank did not provide a temporary extension to cover the period of time to execute the new loan facility. In July, the bank defaulted the loan and charged the small business owner penalty interest rates.

One bank

At the public hearings, it was raised by the Inquiry that:

> … one of the biggest things that came through all the cases we had a look at was around communication and transparency. And the very biggest was different areas of the bank giving very mixed signals to the borrower. And I guess our talking to various borrowers about their expectation is that they assumed when they're talking to a representative of the bank, that what they're told is what the bank thinks.[44]

One example provided was a relationship manager giving a borrower positive indications that the bank was willing to roll over or increase a loan, even to the extent that the bank prepared documentation and provided it to the borrower. Then, out of the blue, another area of the bank asked the borrower for more security or to pay down the loan.

[43] ibid., CBA, 30 November 2016, p. 40.
[44] Transcript of public hearings, NAB, 29 November 2016, p. 25.

Adam Bennett, CBA, discussed this type of confused relationship within banks:

> … obviously the relationship person is having the conversation with the client, they may or may not have the delegation to approve that themselves. They may be relying on another part of the bank—typically the credit function—to make that final determination, but the relationship person would be the primary interface to the client. And is there a risk of that getting misaligned? Yes, but I think it's fairly kind of unusual.[45]

The need for all a bank's representatives to be aware of the bank's position on risk was recognised. Leigh O'Neill, NAB, for example, advised:

> They [customers] see one star … and I will use NAB as an example—it only sees one NAB, it only sees one star … I acknowledge that customers see one star, one NAB.
>
> And we have taken some big steps, and we continue to take some continuous improvement in alleviating that as a possibility of occurrence. So there is the principle by which people operate, which is we ask them to operate under one NAB, so to think about the customer and one communication line to the customer.[46]

Case study: Inconsistent bank

A small business owner had a seven year relationship with the bank and was a 'preferred customer'. He had a track record of managing loan facilities well and consistently met interest payments. He was in regular contact with the bank manager at his local branch.

In the year prior to the loan expiry, the customer's life changed substantially when his wife was diagnosed with Alzheimer's disease; a degenerative condition which required a rethink of their situation and develop a plan to step back from business so that he could take care of his wife. He was the sole carer.

The plan was to finalise some property developments and sell his rural business which would repay the loan and provide a surplus of funds for retirement. He advised the bank manager of his wife's condition and set about the planned changes with the bank. Given his extensive loan history and good relationship with the bank he firmly believed that the bank would continue to support him during the transition.

Prior to his loan facility expiring, the customer requested some additional funds to expedite his planned business strategy. The bank agreed to extra funds in addition to the previous debt. The loan was highly securitised and included the rural business and family home.

At this point the bank's relationship with the customer took an abrupt change.

When the new loan documents were ready, the bank manager requested that they be witnessed by a solicitor. The solicitor advised the bank that he could not determine if the

[45] ibid., CBA, 30 November 2016, p. 44.
[46] ibid., NAB, 29 November 2016, p. 26.

customer's wife understood the loan documents and therefore could not witness her signing the guarantee. The bank manager advised the customer that the bank could not proceed with the loan offer.

Two working days after the loan offer could not proceed, the customer's wife obtained an enduring power of attorney that appointed her husband and he immediately advised the bank manager. The bank manager told the customer that the bank would not proceed with the loan offer. This left the old loan facility in default.

The couple did not have access to funds to purchase food, to pay for essential household utilities, or for medicine. They were reliant on borrowing money from family and the goodwill of neighbours who helped to pay for food and utilities.

3.4 Valuations

Recommendation 8: All banks must provide borrowers with a choice of valuer, a full copy of the instructions given to the valuer and a full copy of the valuation report.

Implementation by 1 March 2017.

Current state

No mandatory sharing of valuation instructions, valuation results or valuation methodology with borrowers, despite borrowers paying for valuations. Some banks already do this and some do not.

Recommended change

All banks to provide borrowers with a full copy of instructions given to the valuer and a full copy of the valuation report (instruction, results and methodology).

Rationale

- To provide borrowers with greater visibility of the valuation process and outcome, which they are paying for.
- To provide a basis for borrowers to have constructive conversations with their banks if required.

Implications for banks

- Banks being more transparent in providing access to information that borrowers pay for.
- Banks becoming more accountable in ensuring that valuations are unbiased.
- Banks having to deal with fewer complaints from borrowers about the valuation process.

Implications for borrowers

- Providing borrowers with more assurance that the valuation process is fair and reasonable.
- Giving borrowers greater access to information and control in the process of loan security valuation and business reviews.

Results of the Inquiry survey

	Four major banks	
	Y (%)	N (%)
2. LOAN CONTRACTS—POSSIBLE REFORMS		
Valuations—provide a copy to borrower when:		
Initiated by bank, no financial default on loan	**75**	**25**
Initiated by bank, financial default has occurred	**25**	**75**
Initiated by receiver, loan under insolvency action	**25**	**75**

Banks require a valuation of secured assets at various stages during a loan. This can include:

- on issuing a letter of offer for a loan
- at regular intervals as stated in the loan's terms and conditions
- when a variation is sought or offered
- on expiry of the loan and when considering offering a new loan at the lender's discretion if the lender perceives the value has declined.

The valuation standards used in Australia are based on International Valuation Standards. The two Australian professional bodies whose members value security for commercial loans using these standards and accompanying guidance notes are the Australian Property Institute (API) and the Royal Institution of Chartered Surveyors. Both also have a code of ethics and require members to have tertiary education as a minimum.

The four major banks convene panels of mainly large valuation firms to undertake non-residential valuations. One major bank also has an in-house valuation team and supplements this with expertise from its panel of firms. Commercial valuations require special expertise. For example, valuing a hotel requires specific knowledge and experience that is different to or not required when valuing a resort development or rural property.[47] A panel firm usually has a range of in-house valuing expertise, or it may outsource to a specific specialist. Banks also claim they keep the price of valuations down by maintaining valuation panels.

When a bank requests a non-residential valuation, it provides the valuer with a written instruction. The valuer also receives the bank's standing instructions. These documents prescribe the purpose, the basis of the valuation.

The API advises that standing instructions are updated every year. A new version has been agreed to by stakeholders, including the major banks, and will be in effect from January 2017. The International Valuation Standards state that a valuation is valid for up to three months.[48]

[47] Meetings with Australian Restructuring Insolvency and Turn around Association, 12 October 2016 and Australian Valuers Institute. 18 October 2016
[48] Meeting with the API 21 October 2016.

Valuation firms are sensitive to litigation by lending institutions. Larger firms, in particular, are allocating more resources to risk management standards and processes for valuation rigor and adherence to industry standards.

Borrowers pay for a valuation but do not see instructions to the valuer, or the valuation report

Banks improve transparency, build greater trust and reduce borrower resentment when they provide borrowers with instructions to valuers and valuation reports, which the borrower has paid for. Doing this also makes it possible for bank and borrower to have constructive discussions on valuations, which is especially important when there are disagreements about valuation instructions and valuation results.

Two major banks currently provide instructions and valuation reports to borrowers. Another major bank says that, in certain circumstances, they do so. However, the position of the remaining banks subscribing to the Code of Banking Practice is unclear. These quotes, from the public hearings held by this Inquiry, illustrate this.

Graham Hodges, ANZ, said:

> … if a customer pays for the valuation we would show them the valuation. And we would show them the terms of which the valuation was requested, so that they've got full access to that. I think, that makes a lot of sense. I mean, it's the customer's, you know, business or assets which are being valued and they will likely have some input into how a valuer, you know, assesses that because they will have more intimate knowledge about it. So, actually, that's our policy and we've been applying that for some time.[49]

David Lindberg, Westpac, said:

> … we will contract the valuer ourselves. We do that because it's cheaper and that saves the customer money. The valuer then will do their work, submit their valuation to us. We, as a matter of policy and process, then will transfer that valuation in detail, along with an instruction sheet that we originally gave to the valuer, so they see both the valuation result and the instruction sheet we gave to the valuer in all instances where it is up to us to do that. So that's how it works.
>
> But we do have polices now that actually do require valuations to be provided. I would be hopeful that, as that policy has taken root and practices have changed, that there is one issue that doesn't become an issue in the future and that it actually is an indication of banks changing. [50]

When the Ombudsman sought confirmation from the CBA:

> So like, we can be confident then today you are making instructions and valuations available to the client who pays for them?

David Cohen, the CBA, said:

[49] Transcript of public hearings, ANZ, 29 November 2016, p. 122
[50] Transcript of public hearings, Westpac, 30 November 2016, p. 13

> As of this morning, Kate, I can't tell you that in every single case we are providing valuations and instructions … Your point we completely take, that is, it's up to us to make sure that does happen. [51]

Lack of understanding by borrowers about the temporary nature of a valuation

Banks require secured assets to be valued at various stages during a loan. A borrower may think that the value of their assets, as determined at the start of their loan remain throughout the loan. International Valuation Standards, however, state that valuations are only valid for three months.

Significant changes to value of security held by banks

The PJC inquiry found the large swings in the value of security held by banks to be an issue. The inquiry analysed a number of valuations where the property value had changed significantly over time. The most significant swings occurred during and just after the GFC.

The GFC, particularly in 2008, had a significant effect on the Australian real estate market. The property market peaked in 2007 and suffered significant falls in value over the ensuing years. Any analysis and comparison of valuations both pre- and post-GFC need to take these significant falls into consideration.

Falls in value in excess of 20 per cent were common for general commercial property. Luxury apartment, lifestyle and tourism style properties suffered significant falls in value, particularly in regional locations. In these locations, reductions in value of greater than 30 per cent were common for apartments and serviced apartments. Development sites associated with these project types suffered even greater value reductions, as the viability of projects evaporated. While the Western Australian economy fared better than many Eastern states, the significant falls in real estate values remained a feature of the market during this time.

The valuations analysed by the Inquiry appear largely to reflect the economic environment and the type of industry. One case examined had a major upward valuation even though the valuation report did not provide convincing analysis to support the upward swing, even though the last valuation for that property was undertaken by a receiver who provided detailed instructions to the valuer on previous marketing efforts.

Case study: Too much information?

A receiver commissioned a valuation of a small rural property. The instructions to the valuer included full details about a previous marketing campaign, how many parties were interested in the property and the details and value of the best offer received. The instructions also indicated that the receiver did not accept the best offer as it was significantly less than the valuation they had obtained only four months earlier.

The receiver's instructions described the second marketing campaign for the property and key details about the auction, who the bidder was and how much the bid was.

The receiver also requested the valuation report within seven days, so as not to put the existing contract in jeopardy.
Not surprisingly, the valuation returned a value very close to the previous auction bid—about half

[51] Transcript of public hearings, CBA, 30 November 2016, p. 13

of the value set four months earlier.

Providing valuations with significant changes, instructions to valuers and valuation reports makes the process more transparent and is central to borrower understanding of valuation rationale.

At times, borrowers will dispute valuation reports. The Inquiry asked banks what avenues borrowers have to discuss disputes. The API and Royal Institution of Chartered Surveyors each have a complaints scheme. However, these complaint schemes cannot be used by the borrower when the valuation involved was commissioned by the bank.

All banks should have a process that allows for significant changes to valuations to be discussed.

Two banks, at the Inquiry's public hearing were receptive to this:

Graham Hodges, ANZ, stated:

> … I think the resolution, as I would see it, would be the customer, the valuer and the bank would sit down together and say why have we got a difference here and presumably have a dialogue around why they've come up with their value and why it might differ from the customer's view. Ultimately we have a document which is done by a professional which we have to rely on which we will rely on, and I guess, from our perspective, maybe we need to reflect inside the bank as to how we would deal with those sort of disputes.[52]

David Lindberg, Westpac, said:

> … someone might have a view of the value of their home that might be different to the view that somebody else might have. We then will give our customer the right to contest it. If that were to happen, what we will do is call a meeting between ourselves, the valuer and the customer. We will ask the customer to present facts that they believe to be salient that weren't considered in the evaluation and if that moves the dial with the valuer, then we will have a new valuation. If it doesn't and the customer continues to disagree with the valuation, we then, in many cases, will go and get a second opinion.[53]

Independence of valuers

Some borrowers are concerned about the relationship between the bank and the valuation firms on the bank's panel, suspecting that valuations are much lower than borrowers expected. Borrowers do not know how banks select their commercial valuation panel, or establish terms of employment for that panel. Greater transparency is needed about how banks do this.

In two cases the Inquiry reviewed, the bank let borrowers choose the valuer (and their quotes) for their properties. Two banks at the public hearings indicated they do so in certain circumstances.

David Lindberg, Westpac, said:

[52] Transcript of public hearings, ANZ, 29 November 2016, p. 29
[53] Transcript of public hearings, Westpac, 30 November 2016, p. 13

> What we will do is we will sit with the customer and we will always give them a range of valuers that they can choose between. We think it's important that they have a say in terms of what valuer we decide to use.[54]

Tim Williams, General Manager, Strategic Business Services, NAB, said:

> … when the loan is still performing whilst it's in the front part of the bank, and its reasonable robust in terms and fairly consistent. So when a new loan is written, and let's just say it has got a commercial element—commercial property—for the sake of argument, then what happens is that there would be a valuation which would be undertaken … The customer would have a choice of three valuers ... which we would say are expert or do have the sufficient background in this particular asset or property. The customer would be given the opportunity to pick which valuer they would like... The instructions to the valuer may be shown at that particular point in time. They may not—not always—not automatically.[55]

3.5 Insolvency process and practitioners

Recommendation 9: Every borrower must receive an identical copy of the instructions given to the investigating accountant by the bank and the final report provided by the investigating accountant to the bank.

Implementation by 1 July 2017.

Current state

There is no consistent or clear practice by banks of providing borrowers with the instructions given to the investigating accountant. This can lead to misunderstanding by the borrower, including why the investigating accountant has been engaged. Some banks only provide the borrower with an edited version of the final report, which may not provide all the analysis, findings or recommendations of the investigating accountant. Providing un-edited information will increase the borrower's understanding of their options and the potential actions of the bank.

Recommended change

Banks introduce a policy to provide the borrower with:

- instructions given to the investigating accountant
- un-edited copy of the final report.

Rationale

- To improve transparency of the role of the investigating accountant and the borrower's understanding of their options and the potential actions of the bank.

[54] Transcript of public hearings, Westpac, 30 November 2016, p. 13
[55] Transcript of public hearings, NAB, 29 November 2016, p. 20

Implications for banks

- Improving communications around the bank's position, options and concerns surrounding their interest in the borrower's secured assets.

Implications for borrowers

- Improving the borrower's understanding of their position, the process and the options available to the bank and themselves.

Recommendation 10: Banks must implement procedures to reduce the perceived conflict of interest of investigating accountants subsequently appointed as receivers. This can be achieved through a competitive process to source potential receivers and by instigating a policy of not appointing a receiver who has been the investigating accountant to the business.

Implementation date by 1 July 2017.

Current state

A perceived conflict of interest can lead to situations where an investigating accountant can recommend that a borrower's business enter receivership and then be appointed as the receiver. There is no legislative or industry barrier preventing an investigating accountant from being appointed as receiver.

Recommended change

- Banks introduce a policy to prevent an investigating accountant from being appointed as a receiver for a borrower they have already reviewed.
- Banks examine mechanisms to competitively source receivers for tasks.

Rationale

To remove the perceived self-serving conflict of interest where an investigating accountant can examine a business, recommend a receivership, and then become the receiver for the bank (often earning substantially greater fees).

Implications for banks

- Increasing transparency of bank actions.
- Avoiding perceptions of conflict regarding the role of investigating accountants and their reports.

Implications for borrowers

- Removing perception of conflict of interest surrounding the role of investigating accountants and their reports.

In Australia, corporate insolvency and personal insolvency are regulated by different entities and legislation. ASIC regulates corporate insolvency practitioners (including receivers, liquidators and administrators) under powers granted to it through the Corporations Act and the *Australian Securities and Investments Commission Act 2001 (Cwlth)* (ASIC Act) for businesses that are insolvent. The Australian Financial Security Authority regulates registered trustees in bankruptcy for individuals experiencing personal insolvency under the *Bankruptcy Act 1966 (Cwlth),* the *Bankruptcy (Estate Charges) Act 1997 (Cwlth).*

ASIC provides regulators with guidance on corporate insolvency practitioners and can also investigate complaints about the conduct and performance of an insolvency practitioner.

Insolvency occurs when a company cannot pay its debts when they fall due.[56] Directors or creditors of a company can take action if they believe the company is about to become insolvent, or is already insolvent. Section 588G of the Corporations Act imposes an obligation on company directors to prevent insolvent trading.

The cases reviewed by the Inquiry deal with banks, as the secured creditor, taking action when they consider that the small business is, or will soon be, unable to pay its debt to the bank.

Where investigating accountants and receivers were appointed, the businesses being reviewed were experiencing financial difficulties and had not maintained their commitments. On this basis, the bank appointed an investigating accountant or receiver.

In the Inquiry, most issues raised dealt with investigating accountants and receivers (particularly receivers and managers) rather than other types of insolvency practitioners.

The use of investigating accountants

The Inquiry reviewed several cases in which an investigating accountant was appointed by the bank to investigate the business. Often, the small business did not properly understand the investigating accountant's role. Indeed, some small businesses expected that the investigating accountant was appointed to rescue them from financial difficulties as opposed to informing how the bank should to protect its security. Trying to rescue a business in difficulty is a responsibility of the company directors. Advice from industry bodies indicates that this should be undertaken far earlier than the time the investigating accountant is appointed.

In several cases reviewed, investigating accountants produced reports detailing their findings. Sometimes the small business received an abridged or edited version of the report, although this is current industry best practice, not standard practice. In one case reviewed, the abbreviated version did not even include the receiver's recommendation on what to do with the business.

Small business is expected to pay for the costs of an investigating accountant. This is usually agreed in the terms and conditions of the loan contract. For a business in financial difficulty, this can be an additional and unwarranted financial burden that can exacerbate its cash flow difficulties.

A bank is not required to appoint an investigating accountant. It can appoint a receiver if the small business is in default. In some cases, the investigating accountant can be appointed as the

[56] Defined in Section 95A, Division 7, Corporations Act.

receiver. The Corporations Act does not prevent this from happening. Professional standards, such as the Accounting Professional and Ethical Standard 110 Code of Ethics 330 Insolvency Services, and the Australian Restructuring Insolvency and Turn around Association Code of Professional Practice for Insolvency Practitioners*,* set out mandatory ethical standards for professional accountants and insolvency practitioners on issues such as independence and conflict of interest. These apply to investigating accountants and receivers who belong to these professional bodies.

Some, who submitted to the Inquiry, are concerned about the investigating accountant's ability to recommend a course of action, such as a receivership, and then being appointed by a creditor to that role. This creates a perceived conflict of interest since the investigating accountant may be acting in self-interest. Submitters believe that investigating accountants would be inclined to recommend a receivership if they believe they may be appointed as the receiver. The lack of transparency created in providing edited investigating accountant reports to the borrower, which may not identify the option of a receivership, only heightens the borrower's suspicion when the receiver is subsequently appointed and it is the same company which undertook the investigating accountant's role.

Assessment of receivers in cases

In the cases reviewed by the Inquiry, a receiver was appointed after a small business had faced financial difficulty for some time and had already been communicating with its bank over cash flow or loan obligations.

Several issues raised in the cases relate to:

- the experience and qualification of receivers to accept a receivership, particularly for businesses in specialised industries
- the due care and diligence of the receiver in undertaking their obligations under the Corporations Act
- transparency around the receiver's actions, particularly with the business's operations and the sale of its assets
- the size of receiver's fees.

Experience and diligence of receiver

One case reviewed raised a concern about the receiver's expertise in managing the business under receivership. This highlights the difference between being familiar with a business and being able to run a business particularly in a specialised industry with an existing workforce.

Case study: A series of unfortunate events

A business was in a regional location and operating in a highly specialised industry. Due to a series of events outside the business's control, it faced a shortage of cash flow for the coming cropping season.

The bank appointed an investigating accountant to assess the secured assets. The investigating accountant reviewed the business and recommended several options including appointing receivers immediately. An abridged version of the report was provided to the business owner but it did not include the recommendation to appoint a receiver.

Approximately six months later, the same company who provided the investigating accountant was also appointed by the bank as the receiver. The receiver, based in the capital city of another state, attended the property on several occasions but largely managed the operation remotely. Given the specialised nature of the business, the receiver relied on existing staff to run the business with the sidelined company director retained as an employee for a specific task. Within two months of this appointment, the business had experienced significant turnover in the critical farm manager position, with two consecutive managers leaving after six weeks of being in the role.

Within five months of appointment, an on-site fire destroyed several of the business's significant facilities and assets. Within eight months of appointment, an equipment failure led to the loss of valuable breeding stock. In addition, there were documented instances of theft of stock by staff and other workplace behaviour issues which impacted on business operations. The business assets were sold after the fire at a price reflecting their dilapidated condition.

The receiver maintains that it met it professional and legislative obligations at all times. The bank raised concern about the receiver's management and conduct of the receivership after eight months. The receiver's total fees were more than $450,000 having been adjusted downward in consultation with the bank. Ultimately, all parties agreed to a settlement.

Receiver actions

A consistent theme of the submissions the Inquiry reviewed, was transparency of a receiver's actions to company directors. The appointment of receivers to any business is usually an emotional and challenging time for company directors. In all submissions presented, the business under receivership was having difficulty with or in dispute with their bank. After a receiver is appointed to manage a business, company directors are limited to statutory roles. From this point, depending on receiver discretion outside of legal requirements, the amount of information provided to company directors can be limited.

Lack of information leads to suspicion and concern, particularly when the receiver is preparing assets for sale. A number of submitters—both inside and outside the terms of reference—raised concerns that they did not receive even basic information on the receiver's fees. Some alleged that receivers even failed to return the business's financial records (in other cases, receivers made genuine effort to inform the submitter in a limited way).

After a receiver is appointed, the flow of information should be sufficient to keep both the secured creditor and company directors abreast of developments which affect them both. This is particularly important when receivers are preparing assets for sale, since this may involve receiving updated valuations and engaging with real estate agents. Providing information to company directors at this stage would inform them of receivership progress, the market for their assets and the likely realisation of assets.

Information should be provided in a balanced way and recognise legitimate concerns and limitations on the receiver releasing information around certain asset sale activities, especially those that could have an impact on the ability of receivers to perform their appointed role and achieve the best price. In several cases, misunderstanding over the current market value of assets prepared for sale and the sale price achieved against previous valuations contributed to frustration of borrowers and allegations of receivers not fulfilling their obligations under Section 420A of the Corporations Act. This section requires receivers to take reasonable care to sell property for market value or the best price that can be reasonably obtained in the circumstances. In these cases, the reporting provided by receivers to secured creditors should also be provided to company directors. The cost of this should be minimised because the same information should be provided to both, within reason.

Receiver fees

A receiver's fees, while normally paid by the bank who appointed the receiver, are ultimately added to the borrower's debt. Many submitters to this Inquiry were concerned and frustrated by this, especially because of the lack of transparency around what receivers are doing. There is therefore no ability to assess time spent against fees charged. In cases reviewed, any information on a receiver's fees provided to borrowers was not broken down.

Even if the sale of secured assets recovers the initial debt to the bank, the added cost of the receiver, once passed to the borrower, increases the level of remaining debt.

The remuneration of receivers appointed by a secured creditor is normally negotiated with, and approved by, the creditor. The receiver works for the creditor. Mechanisms for remuneration include time-based (and prospective fee which is a pre-approved, time-based fee up to a limit), percentage recoverable or a contingency based fee, or a fixed fee. The bank's decision to appoint a receiver is a commercial one. The ability to pass on the cost of the receivership is made possible through the terms and conditions of the loan contracts.

Other parties, such as ASIC, an appointed liquidator or creditor, can apply to the court to scrutinise a receiver's fees, and the court has the power to vary fees. Recently, the courts have been constantly reviewing and scrutinising the cost of receivers and insolvency practitioners for proportionality and reasonableness of fees charged.

In general, the issue of a receiver's and insolvency fees is complex and largely outside this Inquiry's terms of reference.

Insolvency and bankruptcy reform

Insolvency practitioner reforms have recently passed with the *Insolvency Law Reform Act 2016 (Cwlth)*. This Act seeks to improve the regulation, registration and remuneration of insolvency practitioners and more closely align the personal insolvency and corporate insolvency approaches used in Australia. The law received Royal Assent on 29 February 2016 with changes to take effect from 2017. The reforms are wide ranging and cover the:

- registration and remuneration of practitioners with increased powers for ASIC to regulate and review practitioners

- rights of creditors, requests for information and assignment of rights to third parties.

The Insolvency Practice Regulations are being drafted and will outline how certain aspects of the law will be implemented. Further reforms are proposed as part of the National Innovation and Science Agenda, which seeks to:

- introduce a moratorium on *ipso facto* clauses in contracts (whereby a party can terminate the contract upon an insolvency event affecting the other party) where the company is seeking to restructure itself
- introduce a 'safe harbour' for company directors from personal liability of insolvent trading where they have engaged a restructuring professional to help address financial difficulties
- reduce the bankruptcy term from three years to one year.

The cases reviewed during the Inquiry highlighted the interplay between corporate insolvency and personal insolvency, especially where a company director has provided a guarantee as part of the loan agreement. An example of this is when a business has experiences difficulty, receivers have been called in and this has led to the personal bankruptcy of the director and loss of their personal assets, including the family home. The proposed reforms under the National Science and Innovation Agenda hold more value for directors trying to save their business because they will give a business more flexibility in addressing its financial difficulties and, in some cases, more time and opportunity to address financial and operational issues.

Most cases reviewed in this Inquiry involved secured creditor appointed receiverships with significant attention placed on this aspect of insolvency. With this type of case, reforms to insolvency practice undertaken by the United Kingdom (UK) in 2003 are of interest. These sought to change the insolvency culture in the UK by reforming the insolvency laws to focus on enabling a business to continue or, if this is not possible, to maximise returns to creditors that could be achieved other than winding up the company.

The Productivity Commission considered the UK approach in its report on business set-up, transfer and closure.[57] The Productivity Commission noted issues with the UK approach. These have been echoed by the industry body—Australian Restructuring Insolvency and Turn around Association. Issues with the UK approach have led to secured creditors pursuing alternative approaches under the regime.

This Inquiry believes that further consideration should be given to the intent of the UK approach and reforms which could be considered to the conduct of secured creditor receiverships. This could be done in conjunction with other proposed insolvency reforms, such as safe harbour, and should focus on earlier restructuring of businesses to address issues and try to save them.

[57] Productivity Commission Inquiry Report— Business Setup, Transfer and Closure. September 2015, p.414.

3.6 Access to justice

Recommendation 11: The banking industry must fund an external dispute resolution one-stop-shop with a dedicated small business unit that has appropriate expertise to resolve disputes relating to a credit facility limit of up to $5 million.

Current state

Caps set by the FOS exclude many small businesses because they do not have the resources to take their case to the courts**:**

- The FOS is limited to considering disputes of not more than $500,000 arising from a credit facility of not more than $2 million. This excludes many small businesses.
- Small businesses do not have the expertise to challenge banks through the court system.
- There is a substantial asymmetry of power between banks and small businesses.
- Small businesses do not have the financial capacity to hire expert legal advice to help them balance this asymmetry of power.

Recommended change

That an independent EDR one-stop-shop be established with a dedicated small business unit to consider disputes relating to small business lending, up to a $5 million credit facility limit.

This independent body:

- can consider disputes relating to credit facilities up to $5 million
- can award compensation of up to $2 million
- can make a determination that is binding on banks
- can require bank customer advocates to report on determinations to ensure they are enforced
- must investigate and reach a determination within a fixed timeframe.

Rationale

- To increase jurisdictional limits and ensure that almost all small business customers have an avenue to justice (banks claim that more than 98 per cent of lending to small business customers is under $5 million).
- To motivate banks, with compensation of up to $2 million, to attempt to resolve disputes through their IDR before progressing to EDR.

Implications for banks

- Providing a mechanism to encourage banks to address issues early and aim to resolve them through their own IDR.
- Saving money and time by resolving matters outside the court system.

Implications for borrowers

- Providing a genuine alternate dispute resolution option in a forum where the needs of small business are understood.
- Saving money and time by significantly reducing the need for litigation.

Recommendation 12: Banks must establish a customer advocate to consider small business complaints and disputes that may or may not have been subject to internal dispute resolution.

Current state

If a small business customer is not satisfied at the end of an IDR process, they can take their dispute to the FOS, through the FDM (if applicable), or to Court.

Some banks have implemented customer advocates and some have not.

Recommended change

Recently, the industry has introduced customer advocates who have the power to consider disputes that have either:

(a) not been successfully resolved through IDR
(b) has not been through IDR.

The Ombudsman supports this initiative and recommends that a customer advocate be available in each bank to:

- be given access to investigate all areas of the bank
- consider disputes and make quick preliminary determinations
- further investigate when the preliminary determination meets the borrower's expectation, to make a final determination that is binding on the bank
- deal with any loan facility.

The customer advocate cannot prevent a customer from taking a dispute to EDR after the customer advocate has considered it.

The Ombudsman will closely monitor the development of the customer advocate role for a period of twelve months to ensure it is achieving intended outcomes. The Ombudsman will do so by requesting data on issues raised, considered, resolved and transferred to EDR.

Rationale

- To acknowledge that the bank is best placed to resolve a dispute.
- To ensure banks fulfil their need to implement determinations by way of remedies and/or compensation.
- To resolve disputes more efficiently given that customer advocates will have all the information they need at their fingertips.
- To enable banks to fast track disputes when a borrower's physical or mental health is of concern.

Implications for banks

- Providing a clear pathway for fast resolution of disputes for borrowers facing significant hardship.
- Providing rapid improvements to internal processes and systems where systemic issues are identified.

Implications for borrowers

- Providing an alternate dispute resolution option.
- Providing potentially quicker resolution of disputes than EDR, since all information is immediately available to the customer advocate.
- Maintaining borrowers rights to take disputes to EDR.

Recommendation 13: External dispute resolution schemes must be expanded to include disputes with third parties that have been appointed by the bank, such as valuers, investigative accountants and receivers, and to borrowers who have previously undertaken farm debt mediation.

Current state

- The jurisdiction of the FOS does not allow consideration of disputes:

  (a) between a small business and a third party such as valuers, investigative accountants and receivers appointed by the bank

  (b) that have been the subject of FDM, regardless of whether an outcome was achieved.

The only alternative for small business in these cases is the court system, yet:

- small businesses do not have the expertise to challenge banks through the court system
- there is a substantial asymmetry of power between banks and small businesses
- small businesses do not have the financial capacity to hire expert legal advice to help them balance this asymmetry of power.

Recommended change

That the independent EDR one-stop-shop have jurisdiction to consider disputes between small businesses and banks, where disputes relate to the conduct of third parties appointed by banks.

Rationale

- Many problems identified during the Inquiry relate to the conduct of third parties appointed by banks.
- Currently, there is no realistic way to seek redress for these actions. ASIC does not take action on behalf of individuals and the court system is not a viable alternative.
- The lack of accountability must be addressed.

Implications for banks

Encouraging banks to more closely monitor the actions of the third parties they appoint.

Implications for borrowers

Enabling small business borrowers to seek redress for the actions of third parties appointed outside their control but who have a substantial impact on their financial wellbeing.

Recommendation 14: A nationally consistent approach to farm debt mediation must be introduced.

Current state

Each state deals with FDM in different ways. Some are legislated, others are voluntary. The schemes lack consistency and are open to interpretation causing confusion. There are no formal arrangements in Tasmania or the Territories.

Recommended change

Implement a consistent approach across the whole of Australia.

Rationale

- To ensure that all farmers in all states and territories have access to FDM.
- To reduce confusion of both small business and banks over when a small business owner can seek assistance.

Implications for banks

- Ensuring staff can be trained on a nation-wide basis to direct relevant parties to FDM.
- Enabling customer advocates to quickly determine the best EDR scheme.

Implications for customers

- Providing a clear set of alternative forums for considering a dispute.

Result of the Inquiry survey

	Four major banks	
	Y (%)	N (%)
3. DISPUTE RESOLUTION—POSSIBLE REFORMS		
Customer advocate within bank available to small business	**100**	**0**
In proposed one-stop-shop for EDR, have a dedicated small business unit	**75**	**25**
EDR for claims against any party, or related party, to a facility including borrower's agents appointed by the bank	**25**	**75**
EDR access—no loan cap	**0**	**100**
EDR access—loan cap <$1 million	**25**	**75**
EDR access—loan cap <$3 million	**75**	**25**
EDR access—loan cap <$5 million	**25**	**75**
EDR access—loan cap <$10 million	**0**	**100**
Establish a mandatory national farm debt mediation scheme	**100**	**0**

Ramsay Review interim findings

On 6 December 2016, Professor Ramsay published his interim report on his current review into of the financial system's EDR and complaints framework. The interim findings broadly accord with this Inquiry's recommendations.

Key findings relevant to the EDR aspect of the Inquiry include:

- The jurisdictional limits of the FOS create a gap in the EDR framework:

  The Panel found the current monetary limit of $500,000 and compensation cap of $309,000 are no longer fit-for-purpose and bear little relationship to the value of some financial products …[58]

- The draft recommendations support the creation of an industry Ombudsman with higher caps that will be subject to indexation. The Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP, said the response to the recommendations of the Ramsay Review's interim report was overwhelmingly positive, particularly around the proposal for a one-stop complaints and compensation scheme with the power to resolve disputes in a timely manner.

[58] Review of the financial system external dispute resolution and complaints framework, p. 16.

- The rejection of the need for a new statutory tribunal in the finance and banking sector, which consumer advocates strongly. The Hon Kelly O'Dwyer MP said:

  I am particularly heartened by the response from consumer groups who deal directly with people who have experienced long-running disputes with banks and institutions that offer financial products … They understand better than anyone that consumers caught up in disputes need a body that will help resolve their issues quickly and without a drawn-out, expensive, and highly legalistic process.[59]

The rationale for the Inquiry's recommendations

The importance of maintaining a strong relationship between banks and small business borrowers is crucial to the viability of small business. However small business owners feel they do not have any avenue for raising their concerns when difficulties first arise, when they do not necessarily see their difficulty as a dispute and when they consider an IDR outcome unfair.

This inability of small business to access justice for their lending disputes is unsatisfactory and must be addressed.

What is access to justice?

Access to justice is defined in many ways. The Productivity Commission uses the term 'promoting access to justice' to mean 'making it easier for people to resolve their disputes'.[60] This Inquiry notes the Victorian Government's Access to Justice Review, which refers to this observation by Professor Mary Anne Noone, a leading Australian academic in the field:

> … access to justice is not just about access to courts and tribunals and is much more than the resolution of disputes. It encompasses how people navigate and are treated in the many transactions (with legal consequences) that comprise everyday life particularly those that are administered [by] or involve government agencies. It is in these encounters that "equality before the law" is experienced by most people.[61]

In the context of this Inquiry, the Ombudsman views 'access to justice' as the ability of a small business to obtain resolution of a dispute with a bank in a forum and manner that is timely, efficient and affordable. Small businesses are an essential part of Australia's economy. Despite their critical role, they are often disregarded for the purpose of laws and regulations. They only benefit if they are seen to be a 'consumer'.

> … that small business borrowers are often just as vulnerable as residential borrowers as they may have been required to provide their homes or personal guarantees as security for their loans.[62]

A small business in dispute with its bank tries to resolve the dispute through the bank's IDR. When the bank believes the dispute is resolved, it sends the small business a letter providing contact

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[59] Press release issued by The Hon Kelly O'Dwyer MP, 7 December 2016.
[60] Productivity Commission Inquiry Report—Access to Justice Arrangements, December 2014, p. 3.
[61] Access to Justice Review, Victorian Department of Justice and Regulation, October 2014, p. 3.
[62] PJC on the Impairment of Customer Loans, p. 53.

details for the FOS in case the business wants to take the matter further.

Bank customer advocates have stated that banks do not currently advise borrowers of the limits for the FOS jurisdiction. This gives borrowers false hope—they believe they can access the FOS when they cannot.

Access to the Financial Ombudsman Scheme

The FOS is governed by its terms of reference and its operational guidelines (current version 1 January 2015). The terms of reference make it clear that the FOS has jurisdiction in relation to small business. This is defined in Clause 20.1 as:

> 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.

However, the jurisdictional limits and discretionary practices governing the actions of the FOS severely limit the ability of small business to access justice through the Scheme.

Clause5.1 of the terms of reference provides that the:

> [The FOS] may not consider a Dispute:
>
> (o) where the value of the Applicant's claim in the Dispute exceeds $500,000;
>
> (r) about debt recovery against a Small Business where the contract provides for a credit facility of more than $2,000,000 …

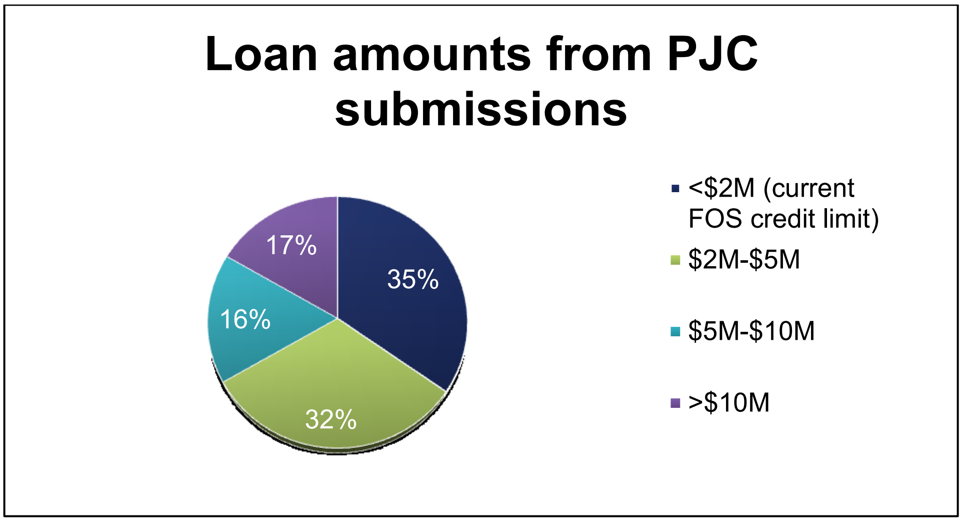
The ASIC Senate Inquiry concluded that:

> … while accepting that an EDR process is intended to provide a low cost, less formal process to resolve complaints for consumers, the committee nonetheless is of the view that the caps on eligibility and compensation appear to be too low. There is a particular problem for small businesses seeking a resolution to a dispute that may breach the eligibility cap or in some other way not qualify under the EDR schemes' terms of reference.[63]

The Inquiry concludes that these caps are too low to provide small business with an avenue to access justice in most cases. This is illustrated by the submissions to the PJC where only 35 per cent of these would have fallen under the FOS's terms of reference.

[63] Performance of the Australian Securities and Investments Commission, Senate Inquiry, June 2014, p. 104.

Figure 5: Breakdown of loan value in the PJC submissions



What is the rationale for the caps?

A $2 million credit facility limit was introduced after the 2013 Independent Review of the operations of the FOS and changes to Regulatory Guideline 139 by ASIC.

In the independent review, concerns were raised that it was inappropriate for the FOS to consider complexity of large credit facilities. An example was some property development disputes about loans in excess of $5 million'. The review considered that the 'FOS should be more active in using its discretions to exclude large and complex business credit disputes'.[64]

ASIC required:

> From 1 January 2014, the Terms of Reference of an EDR scheme must exclude small business lending disputes, where the credit limit of the credit contract that is the subject of the dispute exceeds $2 million, from its debt recovery legal proceedings jurisdiction. We encourage EDR schemes to introduce this change earlier where possible.[65]

ASIC is of the view that 'a $2 million limit best delineates between the types of small business credit disputes that are appropriately dealt with at EDR and those that would be more appropriately addressed in court.'[66]

The PJC noted concerns about some matters falling outside the FOS's jurisdiction, for various reasons. This includes:

- the FOS making a determination that a matter would be more appropriately dealt with by the courts
- the FOS's upper limits on claim size and compensation amounts

[64] Independent Review—Report to the FOS Board, 2013, Section 10.5.3.
[65] ASIC Regulatory Guide 139, RG 139.75, p. 20
[66] Response 348 to submissions on CP 190 Small business lending complaints: Update to Regulation 139, June 2013, p. 9.

- settlements with banks that preclude customers from raising disputes with the FOS
- whether the FOS has the necessary powers
- where other processes, such as mediation, have been used, which may then exclude the FOS from considering the matter.[67]

The FOS considers disputes through mediation. From the start, however, this approach tips the scales in favour of the bank given that:

- banks are familiar with mediation processes used and small business borrowers are not
- small business lenders are aware that if agreements cannot be reached, banks will likely enforce their legal rights (for example, by taking possession of a property or appointing a receiver)

This is particularly the case with FDM where the requirement to hold a mediation before enforcing a mortgage is met as soon as the mediation conference commences, regardless of its outcome. It is possible that a bank that does not participate in good faith in the mediation could still undertake enforcement actions. The practical effect of this is that many small businesses accept ‘settlements’ that they may not have accepted if the threat of enforcement by the banks had not been there.

Once mediation is exhausted, the only option available to small business is lengthy, unaffordable court action.

Independence

Feedback from individuals who contacted the Inquiry, including those raising issues not covered by the Inquiry’s terms of reference, said they believe the FOS lacks independence from the banks. They asserted that the FOS accepts the ‘commercial decision’ explanations of banks without question.

Enforcement

FOS determinations, when accepted by small business, are binding on the banks, however both the FOS and banks have confirmed there is no follow-up or reporting on whether FOS determinations have been implemented.

Case study: The Financial Ombudsman took too long and did the bank fully comply with the determination?

In one case, it was 23 months from the time a dispute was lodged to the date a determination was made. The FOS determined that ‘The FSP [financial service provider] engaged in maladministration in lending when it provided the loans to the Applicant’, and that ‘The FSP must also treat the Applicant as a customer in financial hardship who has made a financial difficulty request’.

Since this time, the FOS has greatly improved its dispute resolution timeframes. However, there is still no follow-up or reporting on whether FOS binding determinations are implemented.

During the period that the FOS considered this dispute, the bank continued recovery action. Before lodging the FOS dispute, the applicant had handed the keys back to the bank for the property that

[67] PJC, Inquiry into the Impairment of Customer Loans, p [47].

secured that loan. The FOS terms of reference are unclear about recovery action ceasing under such circumstances. The bank proceeds with recovery action during the time the FOS considered the case.

The applicant believes the FOS did not provide sufficient compensation. The letter acknowledging the dispute request, the determination and a subsequent letter from the FOS were confusing and unclear to the applicant. The letters are not clear on what compensation the applicant could expect from the determination and how the bank should treat such a hardship application.

The bank provided evidence that it complied with the financial aspects of the FOS ruling. However, when the applicant put in a hardship application, the bank did not accept the terms of the applicant's proposal and gave an ultimatum as to the bank's position—refinance with another lender and pay the remaining debt in three months. The bank appeared to have ignored that the applicant was in financial hardship. The applicant attempted to meet these requirements and failed. The bank has since sold the two remaining properties.

Farm debt mediation

A farmer with a dispute over a farm debt can seek redress under the appropriate FDM scheme. Currently, the approach across Australia is inconsistent. New South Wales and Victoria have legislative schemes, Queensland and South Australia have legislative bills before Parliament, Western Australia has a voluntary scheme only and Tasmania offers FDM through Rural Business Tasmania. The terminology used under these schemes varies. For example, the definition of 'farm business' is unclear, inconsistent and requires interpretation across different state FDM legislation.

The schemes intend to provide farmers with rights to participate in mediation before lenders can enforce their rights under a mortgage. Under FDM schemes, a farmer cannot force a mortgagee to mediate a dispute, although refusal by the mortgagee to attend mediation can lead to the mortgagee being prevented from enforcing its rights under the mortgage for six months.

This temporary deferral of enforcement action does not address the underlying problem for the farmer, which is the inability to meet financial obligations. In this case, or where mediation is not successful, there is no further step that the farmer can take under FDM (with the limited exception of the proposed Queensland legislation which allows for a right to request an internal review and then an external review by the Queensland Civil and Administrative Tribunal of certain decisions).

The FOS refuses to accept jurisdiction in relation to farmers that have already sought FDM, giving rise to a gap in access to justice. The 2013 Independent Review suggests of the operations of the FOS that:

> … where, for example, the farmer has rejected the banks mediation offer or withdrawn from the mediation process, FOS will accept jurisdiction over the dispute. FOS also accepts jurisdiction if the dispute relates to a debt in another state that does not have farm debt mediation legislation. [68]

However, a letter sent to the FOS in 2014 by the Rural Financial Counselling Service in Queensland suggests this is not the case in practice. The 21-day timeframe within which to accept

[68] Report to Board of Financial Ombudsman Service 2013 Independent Review, p. 65

FDM does not allow a farmer to fully consider whether they would prefer to take the matter to the FOS. If the farmer proceeds to FDM, they cannot later go to the FOS.

Where else can a small business borrower go?

If a small business borrower cannot access FOS or FDM, their alternatives are limited, particularly in reaching a binding outcome.

Customer advocate

One industry initiative underway is the appointment of customer advocates to consider disputes not resolved through bank IDR schemes. A customer advocate can also consider disputes that have not been through the IDR. The advocate will first discuss the dispute with the customer to determine if what the advocate can offer meets the customer's expectations. It may be that a customer's expectations will be better met through an immediate referral to an EDR scheme.

The customer advocate is not meant to replace EDR or prevent a customer from pursuing redress through EDR scheme. Instead, the customer advocate works to address disputes quickly and, where the advocate finds in favour of a customer, for the bank to remedy the situation quickly.

In addition to investigating individual disputes, customer advocates will continually review bank practices. Where the advocate finds systemic issues, they will work with that area of the bank to improve processes and ensure agreed improvements are implemented.

The customer advocates in place at the four major banks have direct reporting lines to senior executives. They also report to the Board of the Bank and, in the case of the CBA, a community council. The banks intend to publish the activities and outcomes of their advocates, although when and how is yet to be determined.

Australian Small Business and Family Enterprise Ombudsman

The Ombudsman can assist a small business on banking issues; however, its powers are limited. Although it can recommend alternative dispute resolution, it does not have power to make any binding determination.

Legal action

The Inquiry found that many small business disputes are outside FOS jurisdictional limits, are ineligible for FDM or have unsuccessfully gone through FDM. Since the Ombudsman cannot make determinations and the customer advocate role is relatively untested, this means the only remaining avenue through which many small businesses can access justice is the courts.

Submitters to the PJC argued that accessing justice through the courts is impossible given the difference in resources between small business and banks. As with many areas of the law, banking law is complex. The Corporations Act provisions on financial services run to more than 400 pages of legislation and court rules run to hundreds of pages.

The PJC report states that:

Even in those circumstances where a customer may have a legal case to take to court, the capacity of the banks to "deep-pocket" or out-spend and out-wait the borrower means that court action is often not a viable mechanism for addressing disputes.[69]

Expecting a small business to navigate its way through these provisions and processes is unrealistic. At the point of needing legal assistance, a small business will—more often, than not—be destitute from the recovery actions of banks. A small business rarely has enough money to engage experienced banking lawyers to help with loans and disputes. Many small businesses, not accustomed to the legal world, try to manage without a lawyer.

Previous reviews established that the court system is slow and expensive making it beyond the reach of most small business. The Productivity Commission referred to the fact that:

Some individuals are deterred from pursuing action for fear that the process will prove too slow and costly. One third of individuals who chose not to act on a substantial legal problem cited a belief that it would be too costly as a reason for inaction. A similar proportion thought it would take too long.[70]

The PJC heard that:

For disputes that are outside the jurisdiction of EDR schemes, such as FOS … many customers were prevented from taking legal action because they have lost control of their financial resources, or the cost of legal action excludes all but the wealthiest borrowers. In some cases the commercial nature of their business also rules out access to low cost legal services or Legal Aid. A number of submitters argued that the legal process is too costly for the average borrower.[71]

The Inquiry heard evidence of one lender who could not even pay his electricity bills, never mind pursue a court action.

Time

Most small businesses have limited resources—financially and with the manpower required to deal with a dispute. In its submission to the Australian Consumer Law Review, the South Australia Small Business Commissioner noted in relation to pursuing claims that while:

> … this sort of issue is troublesome for an individual consumer, the time that a small business owner needs to take away from their small business to bring such litigation, and then enforce a remedy, can only result in further losses for that business.[72]

The other concern the Inquiry identified is the potential for court cases to be prolonged which has a much more significant impact on a small business (with limited time and financial resource to pursue a drawn-out case) than it does on a large bank. The impact is not only through financial strain, but the mental and emotional wellbeing of those involved.

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[69] PJC on the Impairment of Customer Loans, p. 31.
[70] Productivity Commission Inquiry Report—Access to Justice Arrangements, December 2014, p. 11.
[71] PJC on the Impairment of Customer Loans, p. 57.
[72] Australian Consumer Law Review Interim Report, October 2016, p. 39.

Asymmetry of power

The PJC heard evidence on the asymmetry of power in court proceedings:

> … banks and their solicitors have perfected the banks' commercial loan documentation to ensure that the bank's interests are thoroughly protected. Mr McNamee suggested that '[t]he result of this is that an SME is unable to resist the will of a bank even in a court of law'.[73]
>
> The contractual balance of power between the bank and the customer has moved so far in favour of the bank in recent years that it is impossible for an SME to challenge a bank in court.[74]

The Australian Government applies 'model litigant' rules to its litigious conduct, recognising the significant power it has in relation to individuals and businesses with whom it has disputes. The Inquiry believes banks should have to apply similar rules to their own litigious behaviour.

Key features of the Australian Government's model litigant rules that banks could apply include:

- dealing with claims promptly and without unnecessary delay
- making an early assessment of the bank's potential liability
- paying claims without litigation, including partial settlements or interim payments, where some liability is accepted
- trying to avoid, or limit, litigation, including by considering alternative dispute resolution
- where litigation is unavoidable, keeping costs of litigation to a minimum.

More detail is in 'The Commonwealth's obligation to act as a model litigant'.[75]

The Inquiry heard evidence of a trial by a bank of an alternative to initiating court proceedings. This involves an independent evaluation by a retired Federal Court judge who reviews available documentation and evaluates the parties' respective legal liability. The parties are not bound by the evaluation but it can be highly persuasive. Although this process is expensive for the bank, it is less expensive and less time consuming than court proceedings. The bank informed the Inquiry that, if the trial is successful, it may be used for future disputes. The Inquiry supports this process as a sensible alternative to litigation.

International developments and best practice

The idea of access to justice has gained momentum again in recent years, with a number of overseas jurisdictions looking into the broader question of whether the justice system is accessible to ordinary people. Examples include:

- Bach Commission on Access to Justice (UK) (ongoing)—interim report issued in November 2016
- Canadian Forum on Civil Justice report—Everyday Legal Problems and the Cost of Justice in Canada: Overview Report (2016)
- Ongoing debate in New Zealand. For example, Justice Winkelman's Ethel Benjamin's address 'Access to Justice—Who needs lawyers?', 7 November 2014

[73] PJC on the Impairment of Customer Loans, p. 58.
[74] ibid., p. 58.
[75] Legal Services Direction 2005, Appendix B (Cwlth).

- Access to Justice in Europe: An overview of challenges and opportunities (2010).

The common thread emerging from these reports and discussions is that justice is not accessible to average people, and legal aid systems are failing those most in need. Urgent reform is required. The reports identify issues common to those raised in this Report in the context of small business:

- On top of financial barriers, access to justice can be impeded by undue delays in judicial process and power imbalance between parties.[76]
- Justice Winkelman notes the high fees payable in respect of New Zealand High Court proceedings: ‘For example for a straightforward proceeding involving a one day hearing, Court fees alone would amount to $6,700.’[77]

In the context of small business, the UK Access to Justice for Litigants in Person report (2011) recognises the plight of self-represented litigants:

> The small landlord, the self-employed individual, the person running a small or medium business enterprise (SME) may not be able to afford the services (at least the full services) of a lawyer. It is estimated by the Birmingham Mercantile Court that 20% of its users were self-represented litigants, mostly SMEs.[78]

Key features of an external dispute resolution for small business

The Inquiry considers that these features need to be present in EDR for small business:

- Simplicity: a system that does not depend on a small business obtaining legal advice. Legal representation is costly and totally unaffordable for small businesses in financial difficulty.
- Timeliness: small businesses depending on access to finance cannot be left in limbo during a prolonged resolution process.
- Solution driven: mediation should be the first step to achieving an outcome as this is most likely to produce a result acceptable to both parties.
- One-stop-shop: Accept disputes between banks and small businesses, including those:
    - relating to the actions of third parties
    - that have been the subject of FDM.
- Powerful: an ability to make binding determinations (that can be enforced), including awarding compensation up to $2 million.

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[76] New Zealand Law Society, *Mind the Gap—closing the justice gap*, 19 November 2015, by James Greenland: http://www.lawsociety.org.nz/lawtalk/lawtalk-archives/issue-878/mind-the-gap-closing-the-justice-gap

[77] Justice Winkelman, Ethel Benjamin’s address *Access to Justice—Who needs lawyers?*, 7 November 2014.

[78] UK *Access to Justice for Litigants in Person* report, 2011, p. 15.

Concerns raised by banks

Appeal concerns

FOS decisions are binding on banks, but not on borrowers. The Inquiry is aware that banks are concerned that increases to jurisdictional limits and compensation caps will expose them to binding determinations without the ability to appeal.

Professional indemnity concerns

According to the PJC report, ASIC stated:

> … it is intended that high value and complex disputes of a more commercial character are excluded from the jurisdiction of the schemes. The level at which jurisdictional limits and compensation caps are set affects all industry participants providing financial services to retail clients and will have particular implications for EDR scheme members who require professional indemnity insurance to meet any claims.[79]

The Inquiry believes that the impact of an increase in jurisdictional and compensation caps on professional indemnity premiums for lending providers will be limited for these reasons:

- Only providers not prudentially regulated require professional indemnity insurance.
- The FOS can provide a broader range of remedies for disputes relating to the provision of credit, resulting in a reduced impact on professional indemnity premiums. For example, with the provision of credit, the FOS may determine that a debt can be waived or that hardship provisions should be offered. This would not have any impact on the amount payable by the credit provider.

To avoid this altogether, the Inquiry considers that caps be increased only for claims relating to small business loans.

4. Regulatory framework

Recommendation 15: Australian Securities and Investments Commission must establish a Small Business Commissioner.

Current state

Some regulators and banks have dedicated positions in their organisations to support small businesses. For example, the ACCC has a Small Business Commissioner.

Rationale

- To ensure the needs of small business are considered under the Corporations Act.
- To provide, through a Small Business Commissioner in ASIC, relevant expertise and a focus on issues that have an impact on small business.

[79] PJC on the Impairment of Customer Loans, p. 50.

Implications for regulators

- Providing specific expertise will assist ASIC staff in their daily operations.
- Building trust and confidence in regulators by small business.

Implications for borrowers

- Increasing confidence that the Corporations Act meets borrower needs.

4.1 Current regulation

The Australian financial system is controlled through many regulatory forms as defined in the Australian Government's Best Practice Regulation Handbook.[80] This includes:

- **Explicit government regulation**—sometimes referred to as 'black letter law'. This comprises primary and subordinate legislation.
- **Co-regulation**—where industry develops and administers its own arrangements (for example, codes and standards) but government provides legislative backing enabling arrangements to be enforced. Sometimes legislation sets out mandatory government standards, but stipulates that compliance with an industry code equals compliance with the standards.
- **Quasi-regulation**—includes a wide range of rules or arrangements where governments influence businesses to comply. These do not, however, form part of explicit government regulation (for example, industry codes of practice developed with government involvement, guidance notes, industry-government agreements and accreditation schemes).
- **Self-regulation**—characterised by industry-formulated rules and codes of conduct, with industry solely responsible for enforcement.

Explicit government regulation

The responsibility for the Australian financial system is vested in four separate agencies. Regulation and supervision is the responsibility of the:

- Australian Prudential Regulation Authority
- Australian Securities and Investments Commission
- Reserve Bank of Australia.

The Australian Treasury has responsibility for broader policy and law reform of the system.

These four bodies comprise the Council of Financial Regulators, a non-statutory body. The Council's role is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. Meetings are chaired by the Governor of the Reserve Bank of Australia. Council members share information, discuss regulatory issues and, if

[80] Best Practice Regulation Handbook, Australian Government, 2010. http://trove.nla.gov.au/work/37896981?selectedversion=NBD45964433

the need arises, coordinate responses to potential threats to financial stability. The Council also advises Government on the adequacy of Australia's financial regulatory arrangements. Various memoranda of understanding and bilateral coordination arrangements exist between Council members.

More information on Australia's regulatory architecture is in the 2004 *Financial System Inquiry Interim Report*.[81]

Co-regulation

EDR schemes are not co-regulations. Rather, ASIC uses a co-regulatory model to oversight the EDR, noting that the schemes existed before ASIC had an approval role. EDR schemes are approved by ASIC. ASIC's role and the criteria it uses to approve the schemes are set out in Regulatory Guide 139 Approval and oversight of external complaints resolution schemes (Regulation 139).[82] ASIC-approved schemes must meet the criteria set out in Regulation 139 on an ongoing basis. They are subject to independent reviews every five years, or for shorter periods if specified by ASIC.

ASIC-approved EDR schemes must be independent. Scheme members do not have to be a member of an industry association. The relationship between members and schemes is contractual. Members are bound by contract with the scheme to abide by decisions of the scheme.

An EDR scheme covers all member activities falling within the scheme's terms of reference and monetary limits on its jurisdiction. For example, a credit provider may engage in consumer credit and require an Australian credit licence (EDR membership is required to get a licence) but their non-consumer lending also falls within the scheme's jurisdiction (subject to terms of reference and jurisdictional limits). The current business lending jurisdiction of EDR schemes is incidental to its jurisdiction over consumer disputes.

ASIC not only approves EDR schemes, it covers complaints made by retail clients. Some small businesses are retail clients (depending on the number of employees—subsection 761G(12) of the Corporations Act). EDR scheme monetary limits for claims do cover high value or complex disputes, but rather most retail disputes. The FOS is consulting on extending its small business jurisdiction—consistent with ASIC's position—to encourage schemes to extend their jurisdiction beyond the legislative minimum (under Regulation 139).

Quasi-regulation

The certification scheme of practising valuers by the API is a quasi-regulation. Certified practising valuers are property industry professionals, all with tertiary qualifications in the field and accredited with the API. To apply for API certification, each applicant must have completed a recognised

[81] http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf
[82] http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-139-approval-and-oversight-of-external-complaints-resolution-schemes/

qualification and have two years of experience related specifically to the certification being sought.[83]

Self-regulation

The codes of practice of organisations such as the ABA and the Mortgage and Finance Association of Australia are self-regulated. Although voluntary, Courts have found that the Code of Banking Practice has contractual force between lenders subscribing to the Code and customers. For example, in National Australia Bank Ltd v Rose [2016] VSCA 169, breaches of the Code were used to set aside guarantees given to support a series of loans for the purchase of investment properties. Code subscribers therefore have a strong incentive to comply.

The Court can assess non-compliance with an industry code of practice when assessing unconscionability under Section 12CB of the ASIC Act. The relative strengths of the bargaining positions of the parties to a transaction can also be considered.

Industry codes play an important role in setting and raising industry standards. They also play an important role in decision making by the approved EDR schemes as their terms of reference require them to have regard to relevant industry codes in making decisions.

FOS codes are a separately operated and funded unit of the FOS. It provides code administration for four financial service industry codes, including the Code and the Customer Owned Banking Code of Practice.

4.2 Small business lending

Regulators

Two small business lending regulators operate in Australia—ASIC and the ACCC.

ASIC is responsible for the enforcement of the Corporations Act and is governed by the ASIC Act. The ACCC is responsible for the enforcement of the Competition and Consumer Act 2010 (Cwlth). Both bodies receive complaints from small business.

With commercial lending, ASIC can only investigate allegations of breaches of the consumer law provisions in the ASIC Act (Part 2, Division 2). These include provisions preventing unfair contract terms, unconscionable conduct and false or misleading representations. While these provisions appear to be of assistance to small businesses with lending disputes, they are not in practice:

Given limitations to our resources and other factors, ASIC's role does not extend to taking actions against lenders or receivers on behalf of individuals or businesses in relation to their private disputes.[84]

Instead, ASIC takes regulatory action where it is in the public interest to do so. Although provisions exist for small business to complain about the conduct of a bank and/or receiver, the likelihood that ASIC will act is remote.

[83] https://www.api.org.au/certifications-0
[84] ASIC Submission to PJC on the Impairment of Customer Loans, p. 8.

As the regulator, ASIC issues credit and financial service licences. Credit and financial service licensees must be members of an EDR scheme. These licensees, many being financial institutions, can, for example, be members of the ABA, Customer-Owned Banking Association, Mortgage and Finance Association of Australia, and Finance Brokers Association of Australia. Credit licences are only required for consumer lending, not for business lending, even if licensees are lending to consumers and small businesses.

ASIC approves EDR schemes. It can also approve codes of practice, although no organisation has so far submitted to have their code approved.

ASIC licenses credit and financial service providers, and registers liquidators. Of the 710 liquidators in Australia, 76 per cent are members of the Australian Restructuring Insolvency and Turn around Association[85] and more than 95 per cent are members of one or more accounting professional bodies.[86] Membership requires adherence to the professional conduct standards promulgated by the bodies.[87]

An insolvency practitioner, being both liquidator and trustee, must comply with statutory and common law duties, specifically the Corporations Act and Bankruptcy Act. Misconduct of liquidators is reported to ASIC and misconduct of trustees to the Australian Financial Security Authority.

The Australian Prudential Regulation Authority (APRA) authorises banks, credit unions and building societies under Section 9 of the Banking Act 1959 (Cwlth). This permits these institutions to carry on banking business in Australia as authorised deposit-taking institutions. APRA seeks to ensure that these institutions conduct their affairs with integrity, prudence and professional skill, that they remain in a sound financial position and do not promote instability in the Australian or New Zealand financial systems. APRA does so primarily by requiring authorised deposit-taking institutions to comply with prudential standards made under Section 11AF of the Banking Act and by collecting data from authorised deposit-taking institutions under reporting standards made under Section 13 of the Financial Sector (Collection of Data) Act 2001 (Cwlth). APRA's prudential regulation of the authorised deposit-taking institutions does not directly address their activities in lending to small businesses and consequently does not concern this Inquiry.

Businesses lending to other businesses are not licensed by ASIC or other regulators and are not members of the associations mentioned earlier in this section. They therefore fall through the regulatory gaps. Credit for business purposes is not regulated under the National Consumer Credit Protection Act. While there was a proposal in 2012 to extend some of the Act's protections to small business, this was not pursued because of concerns that more regulation may restrict lending to small business.

Credit for business purposes is a 'credit facility' under the ASIC Act which includes, for example, prohibitions on making false and misleading representations or engaging in unconscionable conduct. The ASIC Act also prohibits unfair contract terms in standard form contracts for the supply

[85] Australian Restructuring Insolvency and Turn around Association Submission 38 to PJC on the Impairment of Customer Loans.
[86] ASIC's responses to Questions on Notice from the PJC on Corporations and Financial Services, December 2015.
[87] http://www.apesb.org.au/uploads/standards/apesb_standards/standard1.pdf

of financial products and services (including credit). It is therefore ASIC, and not the ACCC, that has jurisdiction in this space. These provisions extended to small business customers from 12 November 2016.

Some of the main associations or institutes representing members of the financial system lending to small businesses are:

- Financial institutions lending to consumers and businesses:
  - Australian Bankers' Association
  - Customer-Owned Banking Association
  - Mortgage and Finance Association of Australia
  - Finance Brokers Association of Australia.
- Insolvency practitioners:
  - Australian Restructuring Insolvency and Turnaround Association.
- Valuers:
  - Australian Property Institute
  - Royal Institute of Chartered Surveyors
  - Australian Valuers Institute.

This list is not exhaustive and not meant to leave out other associations of professionals providing services to lenders and borrowers (for example, Chartered Accountants—Australia and New Zealand, CPA Australia and Property Investment Professionals of Australia).

Both the Credit Investment Ombudsman and the FOS administer EDR schemes. The FOS provides the secretariat for two committees, the CCMC and the Customer-Owned Banking Code Compliance Committee. Both committees are independent monitors, reporting breaches against their relevant codes: that is, the CCMC for the Code of Banking Practice developed by the ABA, and Customer-Owned Banking Code Compliance Committee for the Customer Owned Banking Code of Practice developed by the Customer-Owned Banking Association.

Figure 6: Players in the financial system

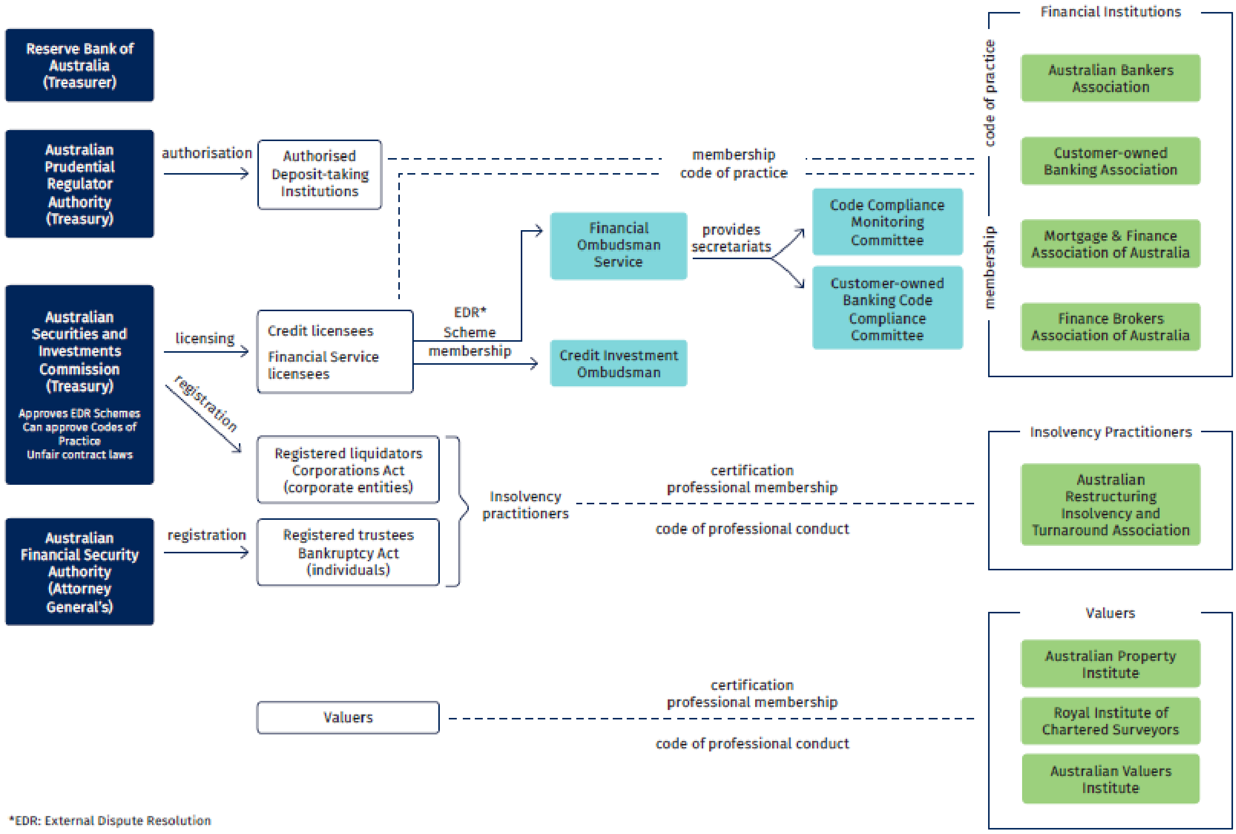


Figure 6 shows the number of players in the financial system lending to small businesses and the relationship between them. The Ombudsman heard during the Inquiry that the organisation of the regulatory framework is siloed. This is demonstrated by the limited number of linkages and checks and balances by regulators on quasi-regulations and self-regulations. Furthermore, it appears that co-regulation models (EDR schemes) are set at minimum requirements and, as a result, leave significant gaps for protecting small business. It is unclear whether regulators and industry schemes have key performance indicators and whether the performance of the schemes is assessed against these. It is best practice to define performance indicators and the government requires all Australian government regulators to do so through its Regulator Performance Framework.[88] The Australian financial system has been reviewed in previous years. Reviews raised issues such as the role of ASIC in the competition space, and innovation in the Murray financial system review. The Future of Financial Advice review recommended a package of reforms, some of which have led to amendments of corporations' legislation. Better links between regulators and non-regulators can be built by establishing an outcome and performance driven framework. Expertise in small business within regulators and non-regulators is required to service small businesses better. The ACCC has a Small Business Commissioner. Some banks have small business advocates, mirroring customer advocates. It is recommended that the ASIC establish a Small Business Commissioner.

[88] https://www.cuttingredtape.gov.au/resources/rpf

Appendices

Appendix A: Terms of reference

Terms of Reference

I, Michael McCormack, Minister for Small Business, pursuant to Part 3 of the *Australian Small Business and Family Enterprise Act 2015*, hereby request that the Australian Small Business and Family Enterprise Ombudsman undertake an inquiry into the adequacy of the law and practices with regard to small business loans, as identified by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) in its inquiry into the Impairment of Customer Loans.

Background

On 4 May 2016, the PJC tabled its report into the impairment of customer loans. The inquiry examined the practices of lenders where constructive default or security revaluation and non-monetary conditions of default have been used to impair the loans of their customers. The PJC determined that there had "... been – albeit in a minority of cases – a persistent pattern of abuse of the almost complete asymmetry of power in the relationship between the lender and borrower".

The Government announced a review of the financial system's external dispute resolution and complaints schemes and on 8 August 2016 released the review's Terms of Reference (the Ramsay Review). The Ramsay Review is to examine the Financial Ombudsman Service (FOS), the Credit & Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal (SCT) to consider whether changes to current dispute resolution and complaints bodies in the financial sector are necessary to deliver effective outcomes for users in a rapidly changing and dynamic financial system.

Scope of inquiry

The objective of the inquiry is for the Ombudsman to identify any deficiencies around the regulation and practices of banks contributing to the vulnerability of small business in borrowing from banks, building on the evidence and information identified by the PJC.

Interim findings of the inquiry will inform work already being conducted through the Ramsay Review.

In undertaking the inquiry, the Ombudsman should:

- review a selection of the cases that have been identified by the PJC as unfair and ascertain whether there are any deficiencies in the regulation of authorised deposit taking institutions in lending to small business

- refer any matters identified in the review to the relevant authority for further consideration as necessary

- determine whether the regulatory deficiencies identified by the PJC, or additional deficiencies identified through the inquiry, are being addressed by subsequent Government and industry reforms; and

- recommend whether additional reform measures should be implemented (legislation, regulations, guidance and practices) to ensure products perform in the way they should, taking into account that consumers have a responsibility to accept their financial decisions, including market losses, when they have been treated fairly, and any impact on the availability and cost of credit to small business.

Process

The Ombudsman must conduct hearings (either public or private), and may consider submissions or undertake other consultation processes.

The Ombudsman must comply with all Commonwealth and state legislation in conducting this Inquiry, including privacy laws.

The Ombudsman should provide its interim findings to the Ramsay Review in 6 to 8 weeks of the receipt of these Terms of Reference.

The Ombudsman should provide a final report to the Minister for Small Business in 12 weeks of the receipt of these Terms of Reference.

Michael McCormack
Minister for Small Business

31/8/16

Appendix B Conduct of the inquiry

Case selection methodology

The Inquiry's terms of reference required it to examine a selection of cases from the PJC inquiry report into the impairment of customer loans. The Inquiry team analysed the PJC report, enabling the Inquiry team to create the evaluation criteria subsequently used to select and examine individual cases.

The evaluation criteria covered these themes raised by the PJC report including:

- unilateral variation of contracts
- loan revaluations
- non-monetary defaults
- unfair or unconscionable conduct
- access to justice
- issues with regulators.

A shortlist of cases was created from submissions that had significant issues relating to the evaluation criteria.

Other factors the Inquiry team considered included:

- financial institutions involved
- timeframe of the dispute
- size of the business
- size of the loan/s
- location of the business
- additional information, including the business had appeared before a public hearing.

The number of short listed cases was supplemented during the course Inquiry because some cases were withdrawn at the request of the submitters. Reasons ranged from having recently settled with the financial institution to not wanting to revisit or relive the issues.

The final shortlist comprised 23 cases. A panel of technical experts examined the shortlisted cases and conducted a deeper-dive review on eight selected cases. The Ombudsman has determined, in line with the provisions of the Act, not to publicly identify the final shortlist of cases due to the confidential and private nature of the submissions.

Some submissions received by the Inquiry team were from members of the public who did not provide a submission to the PJC inquiry. These were outside the Inquiry's terms of reference. Where possible, these cases were referred to the Assistance Team in the Ombudsman's Office for further action. Most of these cases were from individuals who had had issues with their financial institution. Issues included:

- bank practice and operation (including decisions to close branches)
- terms and conditions of loan contracts (including granting power of attorney to a bank)
- behaviour and practice of receivers
- challenges in accessing the court system and understanding the law
- rights and obligations of a small business owner

- role and practice of the FOS
- challenges with bankruptcy.

A sample of the submissions include:

- A family evicted from their home by a bank appointed receiver four days before Christmas.
- Bank administrative errors leading to disputes between customers and banks over securities that did not hold on assets.
- Allegations of collusion between a bank and insolvency advisor about winding up practices which denied funds to more than 1300 small construction businesses creditors.
- Allegations of unfair and inconsistent bank treatment of small business customers on identical issues.
- Concerns about banks delaying customers trying to finalise their relationship with the bank to generate fees or force bankruptcy.
- Concerns about receivers failing to fulfil their duties adequately to companies, including administrative activities and returning property and records to directors at the end of receivership.

Consultation

More than 40 consultations were held with small businesses owners and stakeholders, including:

- small business owners in the cases reviewed
- the ABA
- customer advocates in the four major banks
- industry associations representing providers to banks
- regulators of the financial industry
- government departments.

The list of consultations is at Appendix G.

Information gathering

Following consultations, the Ombudsman issued notices to relevant parties for evidence and documentation in relation to cases being examined. Where further evidence or information was sought, parties were summoned to attend private hearings due to the private and confidential nature of the information.

More than 20 notices to produce information and documents were issued to:

- small business owners of the deep-dive case studies
- banks involved in the case studies
- third parties related to the case studies, such as valuers, investigative accountants and receivers
- FOS
- CCMC.

A roundtable meeting was held with senior executives from the four major banks and the ABA to explore the appetite for reform. Subsequently an Inquiry survey was circulated to all 25 members of the ABA to gauge commitment from individual banks. Ten responses were received, including responses from the four major banks. The questions asked in the Inquiry survey are in Appendix D.

The Ombudsman also summoned the senior executives of the four largest Australian banks to attend public hearings. These hearings sought commitment from the banks to lead industry change, recognising that small business faces unique challenges and that banks must develop practices to support the growth and sustainability of this sector.

Examination phase

To examine the research conducted and information gathered, the Ombudsman engaged a panel of experts from banking, law, insolvency and small business.

Panel members identified areas for further research and additional evidence and documentation to be gathered.

During the examination phase, questions to ask parties at private hearings were developed and areas for discussion in public hearings identified.

A list of the technical experts engaged is at Appendix H.

Hearings

Private hearings were held from 16 November to 6 December 2016. These hearings were based in Canberra, Sydney and Melbourne with participants providing evidence-by phone or video conference from around Australia.

Some individuals and businesses who made submissions to the PJC inquiry attended private hearings with the Ombudsman. These examined the details of cases in-camera to enable frank and confidential discussions.

These hearings enabled the Ombudsman to also hear from some parties who submitted to the PJC inquiry. They allowed the parties to answer questions asked by the Ombudsman, based on information they presented in their submission. The hearings also allowed third parties, such as bank employees, mediators, valuers and receivers, who were involved in some submissions but who may not have submitted to the PJC inquiry, to present information to the Ombudsman so that a balanced view could be formed.

In addition, the CBA, NAB, Westpac and ANZ, participated in public hearings in Melbourne on 29 and 30 November 2016.

Appendix C: Previous inquiries reviewed

Key:

Complete ✓
Incomplete ○
Referred ●

1. Inquiry into the Impairment of Customer Loans, Parliamentary Joint Committee, 2016.		○	
2. Productivity Commission Report on Business Set-Up, Transfer and Closure, 7 December 2015	✓		
3. ASIC Capability Review, 2015	✓		
4. Inquiry into Insolvency in the Australian Construction Industry, Senate Economics References Committee, 2015		○	
5. Inquiry into the Performance of the Australian Securities and Investments Commission, Senate Economics References Committee, 2014	✓		
6. Inquiry into Financial Related Crime, Joint Committee on Law Enforcement, 2014	✓		
7. Access to Justice Arrangements, Productivity Commission Inquiry Report, 2014	✓		
8. Financial System Inquiry, chaired by David Murray AO, 2014	✓		
9. Inquiry into the Corporations and Financial Sector Legislation Amendment Bill, 2013	✓		
10. Inquiry into the Post-Global Financial Crisis Banking Sector, Senate Economics References Committee, 2012			●
11. Inquiry into Competition within the Australian Banking Sector, Senate Economics References Committee, 2011			●
12. Inquiry into Access for Small and Medium Business to Finance, Parliamentary Joint Committee on Corporations and Financial Services, 2011			●
13. Inquiry into Access of Small Business to Finance, Senate Economics References Committee, 2010			●
14. Inquiry into Aspects of Bank Mergers, Senate Economics References Committee, 2009			●
15. Inquiry into Competition in the Banking and Non-Banking Sectors, House of Representatives Standing Committee on Economics, 2009			●
16. Inquiry into Liquidators and Administrators, Senate Economics References Committee, 2010			●
17. Inquiry into Financial Products and Services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, 2009	✓		

Appendix D: Inquiry survey questions to members of the Australian Bankers' Association

Inquiry survey on reforms

November 2016

1. CODE OF BANKING PRACTICE—POSSIBLE REFORMS
Rewrite in plain English.
Submit revised Code to the ASIC for approval under Regulation 183.
Raise awareness with all staff and customers.
Separate the small business section rather than dispersing small business throughout the Code
Include standards on reform measures, such as on timelines for roll over and unilateral changes, use of non-monetary covenants, valuations, IDR and EDR.
Require the CCMC to report for each bank the number of Code breaches in its annual report.

2. LOAN CONTRACTS—POSSIBLE REFORMS
Implementation of Unfair Contract Terms Legislation on 11 November 2016
Contracts for facilities ≤ $1 million amended
Provide a list of terms removed and amended to Australian Small Business and Family Enterprise Ombudsman
Non-financial covenants in contracts for loans
Remove from all contracts
Remove from contracts ≤ $1 million
Agree standards for industry for contracts $1 million to $3 million
Agree standards for industry for contracts $1 million to $5 million
Agree standards for industry for contracts $1 million to $10 million
For the next 18 months, report defaults triggered by non-financial covenants to Australian Small Business and Family Enterprise Ombudsman quarterly
Transparency
Provide a two-page summary of key covenants and potential consequences to borrower
Agree industry standard summary to use
Valuations—provide a copy to borrower of instructions and report when
Initiated by bank, no financial default on loan
Initiated by bank, financial default has occurred
Initiated by receiver, loan under insolvency action

3. DISPUTE RESOLUTION—POSSIBLE REFORMS
Customer advocate within bank available to small business
In proposed one-stop-shop for EDR, have a dedicated small business unit
EDR for claims against any party, or related party, to a facility including borrower's agents appointed by the bank
EDR access—no loan cap
EDR access—loan cap <$1 million
EDR access—loan cap <$3 million
EDR access—loan cap <$5 million
EDR access—loan cap <$10 million
Establish a mandatory national farm debt mediation scheme

Appendix E: Details of ABA six-point plan

Industry Statement

Australia's banks understand that trust is critical to a strong and stable banking and financial services sector. We acknowledge that we have a privileged role in the economy. Our customers, shareholders, employees and our communities rightly expect the behaviour of banks to meet high ethical standards as we look after their financial needs.

For some years now banks have been responding to community feedback to improve customer service and our industry's contribution to the community more broadly. This has been largely successful. While all banks have customer satisfaction ratings above 80%, we acknowledge there is more to do. We continue to implement wide ranging reforms that have already been agreed through the inquiries, reviews and consultations undertaken over recent years.

Subject to regulatory approval, we are committing to a further six actions to make it easier for customers to do business with us and to give people confidence that when things go wrong, we will do the right thing.

We understand the importance of independence and transparency. To ensure this, the industry has appointed Gina Cass-Gottlieb, Gilbert + Tobin Lawyers, to lead the work on establishing the governance arrangements around the implementation of the plan, the review process, public reporting, and the selection of an independent expert to oversee implementation of this initiative. This initial stage will take a month. We will publish public quarterly reports on our progress, with the first report within three months of this announcement.

We believe these actions will further lift standards and transparency across the banking and financial services sector and bolster the existing strength of the regulatory framework.

1. Reviewing product sales commissions

- Building on the 'Future of Financial Advice' reforms, we will immediately establish an independent review of product sales commissions and product based payments with a view to removing or changing them where they could lead to poor customer outcomes. We intend to strengthen the alignment of remuneration and incentives and customer outcomes. We will work with regulators to implement changes and, where necessary, seek regulatory approval and legislative reform.
- Each bank commits to ensure it has overarching principles on remuneration and incentives to support good customer outcomes and sound banking practices.

2. Making it easier for customers when things go wrong

- We will enhance the existing complaints handling processes by establishing an independent customer advocate in each bank to ensure retail and small business customers have a voice and customer complaints directly relating to the bank, and the third parties appointed by the bank, are appropriately escalated and responded to within specified timeframes.
- We support a broadening of external dispute resolution schemes. We support the Government's announcement to conduct a review into external dispute resolution, including the Financial

Ombudsman Service conducting a review of its terms of reference with a view to increasing eligibility thresholds for retail and small business customers.

- We will work with ASIC to expand its current review of customer remediation programs from personal advice to all financial advice and products.
- We will evaluate the establishment of an industry wide, mandatory last resort compensation scheme covering financial advisers. We support a prospective scheme being introduced where consumers of financial products who receive a FOS determination in their favour would have access to capped compensation where an adviser's professional indemnity insurance is insufficient to meet claims.

3. Reaffirming our support for employees who 'blow the whistle' on inappropriate conduct

- We will ensure the highest standards of whistle-blower protections by ensuring there is a robust and trusted framework for escalating concerns. We will standardise the protection of whistle-blowers across banks, including independent support, and protection against financial disadvantage. As part of this, we will work with ASIC and other stakeholders.

4. Removing individuals from the industry for poor conduct

- We will implement an industry register which would extend existing identification of rogue advisers to any bank employees, including customer facing and non-customer facing roles. This will help prevent the recruitment of individuals who have breached the law or codes of conduct.

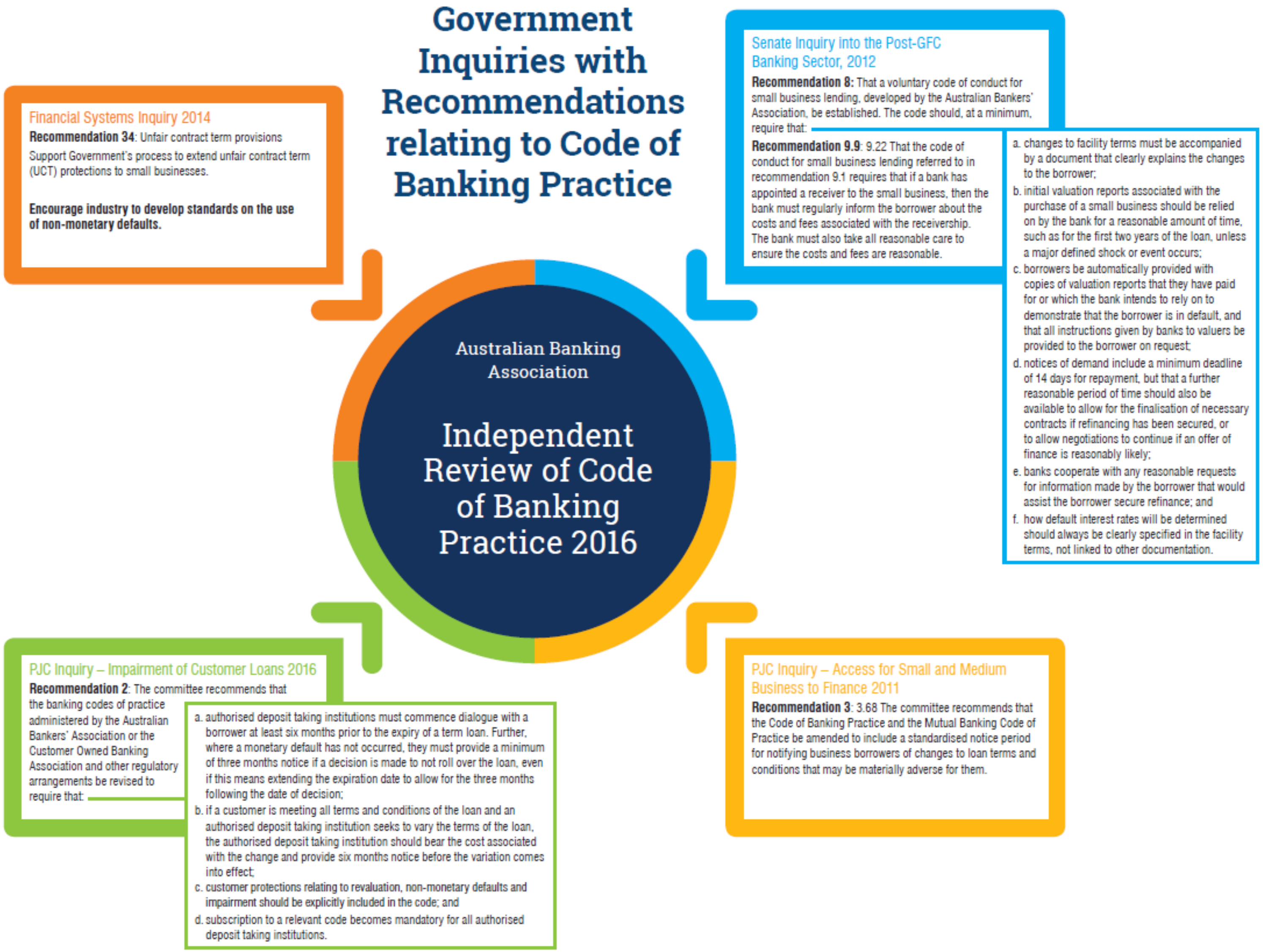
5. Strengthening our commitment to customers in the Code of Banking Practice

- We will bring forward the review of the Code of Banking Practice. The Code of Banking Practice is the banking industry's customer charter on best practice banking standards, disclosure and principles of conduct. The review will be undertaken in consultation with consumer organisations and other stakeholders, and will be completed by the end of the year.

6. Supporting ASIC as a strong regulator

- We support the Government's announcement to implement an industry funding model. We will work with the Government and ASIC to implement a 'user pays' industry funding model to enhance the ability for ASIC to investigate matters brought to its attention.
- We will also work with ASIC to enhance the current breach reporting framework.

Appendix F: Government inquiries with recommendations relating to the Code of Banking Practice



Appendix G: Consultations

Banks, related organisations and individuals

Australia and New Zealand Banking Group Limited (ANZ)

Commonwealth Bank Group (CBA)

National Australia Bank Limited (NAB)

Westpac Banking Corporation (WBC)

Customer advocates of ANZ, CBA and NAB

Australian Bankers' Association

Code Compliance Monitoring Committee (CCMC)

Customer Owned Banking Association

Phil Khoury, Managing Director, Cameron Ralph (ABA review of Code and CCMC)

Ian McPhee, former Commonwealth Auditor-General (banks oversight of ABA review)

Stephen Sedgwick (ABA review of remuneration)

Stakeholders

Australian Property Institute

Australian Restructuring Insolvency and Turnaround Association

Australian Valuers Institute

Certified Practicing Accountants

Commercial Asset Finance Brokers Association of Australia

CoreLogic (RP Data)

Council of Small Business Organisations of Australia

Finance Sector Union

Financial Ombudsman Service Australia

Legal Aid Queensland

Mortgage & Finance Association of Australia

NSW Business Chamber

PricewaterhouseCoopers

Professor Ian Ramsay

Royal Institute of Chartered Surveyors

Rural Business Tasmania

Rural Financial Counsellors

Tasmanian Small Business Council

Regulators

Australian Competition and Consumer Commission

Australian Prudential Regulation Authority

Australian Securities and Investments Commission

Australian Taxation Office

Australian Financial Security Authority

Government bodies

Attorney-General's Department

Department of Agriculture and Water Resources

Department of Treasury

Reserve Bank of Australia

Appendix H: Technical experts

Oliver Wyman

Management Consultants

Andrea Zannier | Partner Financial Services

Johnson Winter & Slattery

Legal Counsel

Matthew Allchurch | Partner

Vincents

Insolvency and Reconstruction experts

Tony Lane | Director

Gower Jones & Co

Forensic Accounting & Business Valuations

Cully Gower | Director

Sneddon Legal

Mark Sneddon | Director

CLEC legal services

Rachel Burgess I Director

Darren King – former bank risk executive