SUBMISSION ON POLICY ISSUES IDENTIFIED IN THE INTERIM REPORT

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Submission for: My Self
Name of other person, business or organisation:
Do you agree to your submission being published: Yes
Do you agree to your full name being published: Yes
Your submission:
The Hon Kenneth Hayne AC QC, Commissioner
Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Dear Commissioner

Submission in response to the Interim Report

Thank you for the opportunity to provide a submission. This is a brief submission in response to one particular issue raised in the Interim Report, that is, whether any lending to small and medium sized enterprises (SMEs) should come within the reach of the *National Consumer Credit Protection Act* 2009 (Cth) (NCCP Act) and, particular, Sch 1 to that Act, being the *National Credit Code* (NCC). I may provide a submission addressing other issues at a later time.

The Interim Report states at p 180: "I have said already that I did not understand there to be substantial support for changing the legal framework in ways that would bring some or all SMEs within the application of the NCCP Act. But I mention that matter again in case there are those who seek to persuade me to the contrary."

In my submission, the provisions of the NCCP Act **should** extend to small businesses, in circumstances where the business is effectively borrowing as a consumer. This is predominantly in order to close the loophole that currently exists permitting lenders to circumvent the operation of the NCCP Act by characterising the loan as one for a "business purpose". I also submit that a similar amendment should be made to comparable protections currently applying only to consumers, such as s 278 of the *Australian Consumer Law* (Sch 2 to the *Competition and Consumer Act* 2010 (Cth)) (ACL). For ease of reference, I refer to such provisions collectively as the "consumer credit protections".

Notwithstanding that the Commission is no longer accepting submissions in relation to past conduct, in order to illustrate broader policy points, it is necessary in this submission to refer to my experiences in practice as a solicitor and, more recently, as a barrister, acting for a number of consumers and small businesses in disputes with lenders. I am able to provide specific details of that experience if requested (subject to my confidentiality obligations in relation to the relevant clients).

Definitions of "consumer"

As the Commission would be aware, the consumer credit protections are generally defined by reference to the purpose for which the credit or service is provided. For example, the NCC applies, relevantly, where (see s 5(1)):

> *"(a) the debtor is a natural person or a strata corporation; and*
>
> *(b) the credit is provided or intended to be provided wholly or predominantly:*
>
> *(i) for personal, domestic or household purposes; or*
>
> *(ii) to purchase, renovate or improve residential property for investment purposes; or*
>
> *(iii) to refinance credit that has been provided wholly or predominantly to purchase, renovate or improve residential property for investment purposes;"*

Similarly, s 278 of the ACL applies only to persons who acquire goods or services which cost below $40,000 or which are "of a kind ordinarily acquired for personal, domestic or household use or consumption": s 3.

I note that recent amendments to s 12BC of the *Australian Securities and Investments Commission Act* 2001 (Cth) (ASIC Act) have extended the definition of "consumer" under that Act to apply to small businesses, so that related protections, such as s 12ED of the ASIC Act, apply to small businesses as well as individuals. My submission is that the operation of the ACL and the NCC should be similarly extended.

Avoidance of consumer credit protections

In my practice, I have encountered a number of disputes with lenders in relation to which a transaction which is in substance the provision of credit to a consumer has been structured in a way that avoids or may avoid the operation of consumer credit protections. This includes, but is not limited to:

1. requiring the borrower to make a "business purpose" declaration (see, r 68 of the National Consumer Credit Protection Regulations 2010 (Cth)), creating a presumption pursuant to s 13(2) of the NCC that the NCCP Act does not apply;
2. credit being provided for investment purposes where the “investment business” was established in order for the borrowers to invest their retirement or household savings, including the equity in their principal place of residence;
3. credit being provided to a small business for business purposes, but being cross-collateralised with a home loan which is subject to the consumer credit protections; or
4. the borrower being a company and not a natural person, meaning that the NCCP Act is excluded from operation, but where the loan is personally guaranteed by a natural person who is a consumer, or is otherwise secured against residential property owned by a natural person.

I address these points in more detail below.

Business purpose declarations and investment purposes

One prominent example of the type of conduct referred to in points 1 and 2 above arose in the Storm Financial cases, referred to in the Interim Report in a different context at pp 82-84. In the interest of full disclosure, I note that I acted as a solicitor for the lead applicants in the related class action against Westpac (see, *Lee v Westpac Banking Corporation* [2017] FCA 1553).

As the Commission observes in the Interim Report, “Almost 90% of Storm’s clients were encouraged to take out loans against the equity in their own homes, obtain a margin loan and use the funds from these loans to invest in the share market via index funds.” In fact, Storm encouraged its clients to borrow money against *any* available equity, including but not limited to their own homes, any investment properties, and any shares they owned, and to use the proceeds (referred to as an “equity contribution”) to invest in index funds. Storm then advised its clients to obtain a margin loan and use the units in the index funds obtained through the equity contribution as security for that margin loan, in order to borrow further funds which were in turn used to purchase further units in the index funds. This left the clients extremely leveraged and vulnerable to the loss of all security property.

Relevantly, while some of the mortgages obtained by Storm’s clients were home loans and self-evidently for personal or domestic use, some of them were characterised as “business loans”, in relation to which the clients signed business purpose declarations. Further, business purpose declarations were also signed in relation to all of the margin loans.

In all of the Storm class actions, claims were made against the banks pursuant to s 72 of the *Trade Practices Act* 1974 (Cth), the predecessor of s 278 of the ACL. In those cases, the respondent banks denied that the applicant Storm clients were “consumers”, relying, where possible, on the business purpose declarations. As the cases all settled, there was never a determination made in relation to that issue. I note that no claims were available under the NCC in relation to Storm Financial as the NCCP Act had not yet come into force when the relevant events occurred, but it is likely that such claims would have been made had Storm’s collapse occurred at a later time.

Two notable examples of unsuccessful attempts to use a business purpose declaration in order to circumvent consumer protections can be found in the decision of the NSW Court of appeal in *Tonto Home Loans Australia Pty Lt v Tavares* [2011] NSWCA 389; 15 BPR 29,699 (see at [296]–[298]) and the decision of the Victorian Court of Appeal in *Violet Homes Loans Pty Ltd v Schmidt & Anor* [2013] VSCA 56; 44 VR 202 (see at [71]-[75]). Both cases concerned consumers who had signed business purpose declarations in order to borrow money against their principal places of residence to invest in certain managed investment schemes.

In *Tonto*, the Court found it unnecessary to decide whether the business purpose declaration effectively excluded the operation of s 12CA of the ASIC Act as it then stood, because the conduct in question was not unconscionable: at [268]. In *Violet*, the Court found that the s 12CB of the ASIC Act did apply, as: (1) an “investment purpose” is not inconsistent with “personal use”, as individuals commonly make investments of personal funds, such as retirement savings; and (2) the credit provided (a “low doc loan” secured against a residential property) was of a type commonly acquired for personal use: at [75].

Note that s 12CB of the ASIC Act has since been amended such that it no longer applies only to a "consumer".

Returning to the Storm cases, notwithstanding the *Tonto* and *Violet* decisions, there may be an argument that the nature of the investments being made by Storm's clients, including the complex index fund and margin lending arrangement described above, took the loans outside of what would ordinarily be considered to be a personal, domestic, or household purpose. This can be seen by the fact that the respondent banks in the Storm Financial cases continued to dispute whether Storm's clients could be characterised as "consumers" even after the decisions in *Tonto* and *Violet*. Presumably, the banks must have considered that there remained at least a reasonable prospect that those defences would succeed.

However, from a policy perspective, it would be difficult to argue that Storm's customers were not the type of people who ought to have the benefit of the consumer credit protections. For the most part, they were unsophisticated retail investors who were investing their life savings in accordance with Storm's advice. In my submission, there should not be any ambiguity as to whether the consumer credit protections apply to persons in the position of Storm's clients, and lenders or intermediaries should not be able to circumvent the operation of the consumer credit protections by encouraging their customers to adopt borrowing structures which appear on their face to have a business purpose.

Cross-collateralisation and personal guarantees by consumers

I now address points 3 and 4 above. I do not do so by reference to any prominent case studies, such as Storm Financial, but I nevertheless do so by reference to my experience in practice. As stated above, I am able to provide examples if requested.

In my experience it is common practice for lenders who provide finance facilities to small businesses to require:

1. that the principals of the business give a personal guarantee in relation to the loan; and/or
2. that the loan be cross-collateralised with the principal's home loan.

In relation to personal guarantees, note that whilst s 5(1)(a) of the NCC provides that the *debtor* must be a natural person or a strata corporation, that is not the case where the debtor is a company and loan is guaranteed by a consumer or secured against a consumer's property. This means that the operation of the NCCP can be avoided by the lended requiring the borrower to be a company, but also requiring a personal guarantee from the company's principal or that the principal offer his or her property as security.

I have encountered arrangements in the course of my practice which are structured in this way and are transparently imposed by lenders for the specific purpose of circumventing the NCC—including where the borrower company was apparently incorporated for the specific purpose of being the borrowing entity and it has no assets and no trading activity except for the loan, but the loan is secured by personal guarantee from the company's directors and shareholders and by mortgage over their real property, including their principal places of residence.

In relation to cross-collateralisation, I have encountered situations where the initial provision of credit is a home loan secured against real property, but the same lender subsequently provides further credit and, in order to avoid the application of the NCC, the further credit is provided to a company and subject to a business purpose declaration. However, the original borrower is a director and shareholder of that company (often the sole director and shareholder) and the credit is secured against the same security as the initial home loan. There is also a cross-collateralisation arrangement entered into, such that a default on the "business loan" causes a default on the home loan.

The effect of such arrangements is to allow what is in substance a consumer credit transaction to occur whilst avoiding the application of the consumer credit protections.

Policy recommendations

In the circumstances outlined above, I submit that the following amendments should be made to the applicable legislation:

1. s 5(1)(a) of the NCC and s 5 of the NCCP Act should be amended, such that the definition of "credit contract" applies not only where a natural person or a strata corporation is a borrower, but also:
   1. where:
      - a natural person provides a personal guarantee in relation to the debt; or
      - the loan is secured against residential property that is owned by a natural person; and, or alternatively;
   2. where the borrower is a small business.
2. s 5(1)(b) of the NCC should be amended, such that the Code applies to the provision of credit where the credit is provided or intended to be provided wholly or predominantly for:
   - a small business purpose (adopting the definition in s 12BC of the ASIC Act); or
   - the purpose of investing retirement or household savings, whether or not as part of a business.
1. s 5 of the NCC should be amended, such that the if the Code applies to the provision of credit under a credit

contract, it applies to the subsequent provision of further credit by the same lender to the same borrower, or by the same lender and secured against the same property, regardless of the purpose for which the credit is provided.

2. s 278 of the ACL should be repealed from the ACL and a provision in like terms should be inserted into the NCCP Act, such that it adopts the definition of “credit contract” in the Code.

Please contact me if there are any queries in relation to the above.

Yours faithfully,

Daniel Meyerowitz-Katz
Barrister, [redacted]
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