ROS GRADY
FINANCIAL INCLUSION – REGULATORY DESIGN
24 October 2018

SUBMISSION ON INTERIM REPORT: ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

1. Small and Medium Enterprises

Issue (Chapter 10, page 333 of Interim Report):

The most general issues emerging from consideration of lending to small and medium enterprises can be identified as being:

- *Should there be any change to the legal framework governing small and medium enterprise (SME) lending?*
- *In particular, should any lending to SMEs come within the reach of the National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act)?*

Executive Summary

Small business lending should be covered by the National Consumer Credit Protection Act 2009 (Cth) (NCCP Act).

The issue, in summary, is whether Australia's stringent consumer credit laws should protect small businesses. The answer should be an unequivocal yes. This is because of the information asymmetry and power imbalance issues affecting small businesses and in the interests of creating a level playing field in the regulatory framework covering consumer / small business credit. And there does not seem to be any evidence that access to credit would be adversely affected by this approach. In this regard it needs to be borne in mind that the Code of Banking Practice already applies to credit services for small businesses. And the Corporations Act protective provisions applies to non – credit financial services. It does not appear that access to any of these services has been adversely affected by this approach.

Reasons for submission

The importance of small businesses to Australia's economy was acknowledged by the Royal Commission. The Interim Report notes that they represent around 97.5% of all businesses (in number) and employ about 44% of people in the private, non – financial sector (page 159). Many of these businesses are operated by individuals, with no or very few employees.

At present our consumer credit laws protect only a natural person who applies for credit wholly or predominantly for personal, domestic or household purposes. This is subject to limited coverage for strata corporations and residential property investment credit. Our credit laws are in the NCCP Act, and the related National Credit Code.

The Interim Report rightly notes that small – business purpose credit facilities are covered by generic protective provisions, especially those in the Australian Securities and Investment

Commission Act 2001 (ASIC Act).[1] They include provisions relating to misleading and unconscionable conduct, unfair terms and implied warranties (e.g. as to fitness for purpose and rendering of services with "due care and skill").

However, small businesses miss out on National Credit Code protections. They include those relating to responsible lending, transparency of credit contracts, limits on interest charges and fees and charges, hardship applications, related mortgages and guarantees, notice of changes to credit contracts and ending and enforcement of credit contracts (amongst others). And small business lenders do not need to hold a credit licence under the NCCP Act, with all its associated responsibilities (e.g. to act "efficiently, honestly and fairly" and in relation to dispute resolution, compensation and responsibility for representatives (e.g. staff and intermediaries[2]). The Interim Report notes that 80% of lending to small businesses is from banks who do hold such licences. However, those licences do not protect small business borrowers as they only apply to consumer credit activities.[3]

The traditional reason for excluding business credit from consumer credit protection laws is that businesses should have the financial sophistication and resources to be able to protect themselves. Other concerns relate to the limited resources of our market conduct regulator, ASIC, and the need to take a proportionate approach to regulation – so we should not impose an unreasonable compliance burden on our financial institutions.

But these arguments ignore the compelling case for protecting small businesses when they borrow. Most fundamentally, both Individual consumers and small businesses may be vulnerable to market misconduct and abuses (e.g. mis-selling) in the financial services industry and suffer from the adverse consequences of information asymmetry, power imbalances and financial literacy challenges.

Another consideration is that it is often difficult to assess the purpose for which credit is to be provided – business or personal. Financial institutions currently have to grapple with this question every time they lend to an individual running a small business – what is the predominant purpose for which the credit is to be used? Do they have to comply with the disclosure and conduct provisions in our consumer credit laws? Surely, it would be simpler and more efficient for both individuals and their bankers to know that these laws apply to all individuals no matter the purpose for which they borrow and to any corporatized "small business" as defined.

And it makes no sense that small businesses are protected by the Corporations Act 2001 (Corporations Act) provisions that apply to financial services other than credit, but do not have the benefit of the NCCP Act. So, if a small business takes out (for example) a savings, insurance, payment or investment product then they have the benefit of the far-reaching protections in the Corporations Act. But they have no such protection when they borrow for business purposes.

Another example of inconsistency in approach is that the Australian Code of Banking Practice applies to "small businesses" (albeit differently defined from the definition in the Corporations

[1] Interim Report, pages 163 and 164
[2] Section 47
[3] National Consumer Credit Protection Act 2009, section 47 and related definitions – especially section 6 definition of "credit activity"

Act). The Financial Ombudsman Service also applies to certain small businesses.[4] However, there are of course differences between the definition of a "small business" in the Code and for the FOS, as compared to the definition which applies in the Corporations Act. Which is a shame.

Would access to credit for small businesses be adversely affected by the application of the NCCP Act and the National Credit Code to small businesses?[5] Especially for new businesses who have no trading history? It is difficult to believe that might be the case, when no evidence has been presented that access to credit has been restricted for individual borrowers with no credit history who come under the NCCP Act or for small businesses who are covered by the responsible lending provisions in the Code of Banking Practice. Further, as noted above, small businesses are currently protected under the Corporations Act in relation to non – credit financial services. Is there any evidence that access to those services has been adversely affected as a result?

The expansion of financial consumer protection laws and codes to cover "small businesses" is increasingly being recognized internationally, including those relating to credit facilities. This is the case in, for example: South Africa[6]; Belgium[7]; Ireland[8]; and Canada[9]. The Financial Conduct Authority in the United Kingdom (**FCA**) has also confirmed plans to expand access for SMEs to the Financial Ombudsman Service.[10] The FCA also noted the lack of regulation in relation to commercial lending in its recent statement on the treatment of SMEs within the Royal Bank of Scotland's Global Restructuring Group.[11] Reference was also made in this FCA statement to the recently introduced Senior Managers Regime, which can apply in relation to commercial lending activities.[12] However, it is to be noted (with regret) that the European Union Directive 2008/48/EC on Credit Agreements for Consumers[13] (and related Directives) only apply at this stage to natural persons acting outside their trade, business or profession.

Conclusion

At a minimum, our consumer credit laws should apply to the same small businesses that are protected by the Corporations Act in relation to other financial services. This is in the interests of fairness, protecting the vulnerable and consistency in our regulatory framework.

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[4] https://www.fos.org.au/small-business/our-small-business-jurisdiction/
[5] Interim Report, page 163
[6] National Credit Act 2005 (South Africa): see section 4 *Application of Act*
[7] Belgium has a law on SME Financing. I was not able to obtain a copy of this law but see the description of the law at: file:///C:/Users/Ros%20Grady/Downloads/belgian_new_law_sme_financing_6021505.pdf
[8] See the Central Bank of Ireland 2012 *Code of Conduct for Business Lending to Small and Medium Enterprises,* which applies to all regulated entities. https://www.centralbank.ie/docs/default-source/Regulation/consumer-protection/other-codes-of-conduct/42-gns-4-2-7-code-of-conduct.pdf?sfvrsn=4
[9] See the Model Code of Conduct for Bank Relations with Small and Medium -Sized Businesses: https://www.cba.ca/small-business-banking-code-of-conduct
[10] See FCA press release at: https://www.fca.org.uk/news/press-releases/fca-confirms-greater-access-smes-financial-ombudsman-service
[11] See *Statement on the Financial Conduct Authority's further investigative steps in relation to RBS GRG,* July 2018: https://www.fca.org.uk/publication/corporate/statement-on-fcas-further-investigative-steps-in-relation-to-rbs-grg.pdf
[12] Op cit, page 14
[13] https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:32008L0048

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2. ASIC's Regulatory Response

Issue (Chapter 10, 8.1.4):

- Has ASIC's response to misconduct been appropriate?
- If not, why not?

Submission

ASIC's response has clearly not been appropriate. This is based on the findings in Chapter 8 of the Interim Report. I work throughout the world on financial consumer protection regimes and Australia's is undoubtedly one of the most far – reaching there is. But the Interim Report's findings suggest that financial institutions routinely ignore it and have not been effectively punished for doing so. Which is both astonishing and sad. Enforceable undertakings, when they first started to be used, created a real reputation risk and were apparently a concern for financial institutions. But when "everyone had one" , and financial institutions realised they could negotiate their way out of a breach of the law, such undertakings ceased to be effective. Civil penalties, infringement notices and banning orders also seem to have been ineffective in preventing future breaches of the law.

It is critical to explore in depth why ASIC has failed to effectively enforce market conduct laws. What are the reasons which are driving this conduct? This should be done before leaping to a solution (such as changing ASIC's remit or requiring prosecutions to be launched in all cases where there is a reasonable prospect of proving contravention). Possible reasons include:

- **Regulatory capture:** Where does the industry influence over ASIC come from? This is the most fundamental question. The answers are not clear but these are some possibilities: ASIC's industry funding model and excess industry influence coming from ASIC's External Panels (is ASIC simply too close to industry and are there enough independent representatives on these panels?). Also – is there a revolving door between industry and ASIC which is of concern?[14]
- **Lack of accountability: D**oes the Australian Government Regulator Performance Framework adequately cover enforcement issues for ASIC? Is there enough assessment of the extent of misconduct in the financial services industry (as opposed to simply publishing enforcement metrics)? Are ASIC's annual report requirements adequate?[15] Do they need to be more detailed on the issues of concern?
- **Lack of regulatory resources:** This could be lack of resources from a monetary point of view and possibly also from the skills and expertise available to ASIC. Does ASIC have what it needs in terms of skills and expertise to develop, and implement, a credible enforcement policy?
- **Limited powers:** Whilst there may be gaps in ASICs' powers, as noted in the Interim Report, ASIC has powers which it does not use.

[14] There is much academic research on this issue, which is often discussed in the context of the United States (but not exclusively). See, for example, http://www.ferdi.fr/sites/www.ferdi.fr/files/publication/fichiers/p122-ferdi-brezis_and_cariolle-october_2016_0.pdf

[15] Australian Securities and Investments Commission Act 2001, section 36

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