Response to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Commercial & Asset Finance Brokers Association of Australia

2018

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Association of Australia

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The Hon Kenneth Hayne AC QC
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Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
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26 October 2018

Response to the Interim Report

The Commercial & Asset Finance Brokers Association (CAFBA) welcome the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Commission). CAFBA has reviewed the Interim Report with interest and provided a response that covers all questions relevant to our sector in order to assist the Commission with preparing a final report.

Our responses to the Commission's Interim Report focus on questions that emerged in Section 4 Small and medium enterprises (pp. 159) and Section 6 Agricultural Lending (pp. 225). We have also addressed specific questions subsequently raised in Section 10 Issues that relate to the work of our members (pp. 327).

CAFBA would like to thank the Commission for ensuring that those working with small business have been heard. It is clear that the Commission understands that small business lending is significantly different to general consumer lending. As the issues that have arisen in consumer finance are not replicated in SME lending, the response must be different. Australian small businesses would be concerned if proposed changes to the financial services environment limited the ability for SMEs to access finance.

We are pleased to see that the Commission has taken the view that more regulation and legislation is not desired by the SME sector. Small business advocates, such as the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) and Council of Small Business Organisations of Australia (COSBOA), agree with CAFBA that it is important for us to avoid increased regulation or the expansion of the NCCP to small business.

Further information is provided below. Should you wish to engage with us further on these or relevant matters, you can make contact our CEO, David Gill, on ceo@cafba.com.au.

Yours sincerely,

David Gandolfo
President

Kathryn Bordonaro
Vice President

Background on CAFBA

The Commercial & Asset Finance Brokers Association of Australia (CAFBA) is the peak national body of commercial and equipment finance brokers, whose prime area of business is the distribution of commercial equipment finance facilities to their clients. With over 700 members, in all states and territories, CAFBA is an expert national voice in the Australian finance sector.

CAFBA members are career professionals, with recent studies showing nearly 67% of new commercial equipment finance is sourced through brokers (East & Partners 2017). Our members and their clients are predominantly small to medium-sized businesses and operate in the commercial finance market. The total receivables in the Australian equipment finance market are approximately $100 billion, so it is an important component of the Australian economy.

CAFBA members know that providing Australian small businesses with access to finance is crucial to economic growth. Although brokers are commonly associated with home loans, CAFBA members work in a complex environment to provide a boutique service. Without the work of CAFBA's professional members, many Australian small business owners would struggle to navigate the complexities involved with commercial equipment finance.

CAFBA embodies the strengths of its members in a unified approach in dealing with financiers and legislators at a national level and regularly seeks the views of members. As an association, CAFBA provides the framework and support to professionally assist our members in their daily activities. This involves education and training, legislative and regulatory updates and forums where the members can interact and exchange ideas with their peers.

CAFBA prides itself on being self-regulating and maintains strict membership standards on probity, continuing professional development, industry experience, and reputation. It is a condition of CAFBA membership that commercial equipment finance brokers must belong to an ASIC-approved External Dispute Resolution (EDR) Scheme.

CAFBA is a member of the COSBOA and works collaboratively with the government, regulators, and business groups.

CAFBA Responses to Questions Raised in the Interim Report

Section 4 – Small and medium enterprises (pp. 159)

CAFBA members are pleased with the Commission's approach to examining and summarising inquiries relating to small and medium enterprises. In particular, our members appreciate that the Commission has worked to effectively distinguish challenges in consumer lending and SME lending. The SME lending space has not been characterised by the same challenges as those within household and domestic finance. As stated within the Interim Report "small business representatives consulted in the course of the Khoury Review of the Code of Banking Practice…said that they did not have concerns about irresponsible lending to small businesses" (pp. 163).

As Commissioner Hayne has noted, there is not an appetite for an increase in regulation and legislation for SME lending. We believe the following reflection is accurate: *"The evidence and submissions provided to the Commission did not reveal any great appetite to change the legal framework. In particular, 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"* (pp. 164).

CAFBA, along with small business advocates, including COSBOA and the ASBFEO, believe that we need to ensure that the SME finance sector is not over-regulated. Ensuring flexibility within SME finance is important for access to finance, particularly to start-up and emerging businesses.

In concluding Section 4 of the Interim Report, three general issues emerged (pp. 180). CAFBA would like to respond to two of these issues.

Apart from existing rules prohibiting unconscionable conduct and rendering unfair contract terms void, should there be some additional rules that govern what a lender can or cannot do before it brings a loan to an end or it seeks to enforce repayment?

CAFBA believes that lenders should act in line with the updated Australian Banking Association Code of Banking Practice. All lenders should belong to an External Dispute Resolution (EDR) scheme approved by ASIC and the Australian Financial Complaints Authority (AFCA). Ensuring that the EDR scheme applies to all lenders supports the protection of SME borrowers, while not adding the burden of applying the NCCP to all SME lending.

If a lender makes a loan that a prudent and diligent lender would not have made, what should an EDR like FOS (now the Australian Financial Complaints Authority – AFCA) direct the borrower and the lender to do?

CAFBA believes that the AFCA should support the borrower to get back to a position where they would have been before the loan was made. The role of an EDR scheme should not be to award additional compensation. Loans and business operations are not without risk and there is always some financial losses that can occur.

Section 6 – Agricultural Lending (pp. 225)

Many CAFBA members are based in regional communities around Australia and are active in supporting local small businesses. Our members provide an important service to rural and regional communities, in particular agricultural businesses, where business owners may not have direct access to financial services. This is a positive aspect of the work of commercial finance brokers as we provide financial choice to regional areas. Our members who work directly in these areas have supported CAFBA to provide the following responses to questions asked within the Inquiry Report.

How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events?

An increased number of specially trained agricultural lenders that are based outside of capital city locations will greatly assist with ensuring lending is tailored to suit regional risk profiles.

Does the 2019 Banking Code of Practice provide adequate protection for agricultural businesses? If not, what changes should be made?

CAFBA members believe that the 2019 Banking Code of Practice does not provide adequate protections for agricultural businesses. Our members are concerned that a large proportion of agricultural businesses would fail the small business criteria set out in the BCP, and would be treated as large business, resulting in a significant reduction of their protections under this Code. As stated below, the BCP must raise the debt level cut-off from $3 million to $5 million.

How, and by whom should property offered as security by agricultural businesses be valued?

To avoid the potential for a conflict of interest or the perception of a conflict of interest, valuers should be independent. In particular, they should not be connected with the bank originating the loan or credit teams.

Is market value the appropriate basis?

Market value is the most appropriate basis for agricultural businesses to be valued. Market value is the most simple and easy value to determine at any given time. The “forced sale” value at the time of a future default is near impossible to determine. The loan-to-value ratio or lending margin of the asset class needs to be set to cover the effect of external shocks on the value of the property.

Is the possibility, or probability of external shock sufficiently met by fixing the loan-to-value ratio?

CAFBA members believe that the possibility of external shock is sufficiently met by fixing the loan-to-value ratio. Most banks already apply lower lending ratios to agricultural properties

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than residential/commercial properties. This could be extended to take into consideration the geographic location of the farm, and the likelihood of that region experiencing an external shock, for example, a drought, flood or cyclone.

If prudential standard APS 220 is amended to require internal appraisals to be independent of loan origination, loan processing and loan decision processes, when should that amendment take effect?

CAFBA believes that the amendment should take effect immediately for new valuations. Valuations are the area where the potential conflict of interest for bank employees is most obvious. Adopting this amendment would significantly increase the workflow of independent valuers, allowing banks sufficient time to create independent internal teams of valuers. Most banks only require revaluation of security properties every three years, which should limit the additional workflow in the short-term.

Should distressed agricultural loans be managed only by experienced agricultural bankers?

Distressed agricultural loans should only be managed by experienced agricultural bankers. The primary reason for this is that agricultural loans are incredibly complex and the situations surrounding these loans require delicate management. Only experienced agricultural bankers have the skills and depth of understanding to be able to manage the file effectively and compassionately.

Do asset management managers need more information (such as the cost to the lender of holding the loan) to make informed commercial decisions about management of distressed agricultural loans?

Asset management managers need more information. Knowing the cost of holding the loan would be a benefit for all parties involved (bank, borrower, mediator). This information should be determined as soon as the loan goes into default and assist with formulating the strategy to how the loan is to be managed, for example: rehabilitated or exited based on the cost of holding.

Are there circumstances in which default interest should not be charged?

There are certain circumstances where default interest should not be charged. In particular, when the loan default is due to unforeseeable and/or uncontrollable events, such as natural disasters, changes to government regulation, outbreaks of pest/disease, acts of terrorism (e.g. recent events in the strawberry industry).

In particular, should default interest be charged to borrowers in drought-declared areas?

Default interest should not be charged to borrowers in drought-declared areas as this only adds to financial stress, and mental health issues. The nature of drought also means the default interest could be charged for many years and can significantly increase the size of the loan if not being met by the borrower.

If it should not, how, and where, is that policy to be expressed?

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The policy of not charging default interest in drought-declared areas should be tied into the Government's Drought Assistance Package or Disaster Relief Packages. As soon as an area is drought/disaster-declared and eligible for Government Drought Assistance package, banks should stop charging default interest.

Should the policy apply to other natural disasters?

Yes, and should also apply to other unforeseeable and/or uncontrollable events, such as natural disasters, changes to government regulation, outbreaks of pest/disease, acts of terrorism. All these events are out of the control of the borrower.

In what circumstances may a lender appoint an external administrator (such as a receiver, receiver and manager or agent of the mortgagee in possession)?

As soon as a loan goes into default farm debt mediation should commence, which will bring all the parties to the negotiating table and be mediated by an independent professional. This mediation should determine whether the borrower's business is viable in the long-term, and the cost to the bank of carrying the defaulted loan. In lieu of charging default interest during this period, the bank should be able to pass on the full cost of holding the defaulted loan to the borrower. This should continue whilst a strategy is formulated for either the loan to be rehabilitated or exited through refinance or asset sale. If the bank and borrower are unwilling to negotiate in "good faith" and cannot agree on a strategy, and it is agreed by the mediator, then an external administrator should be appointed.

Is appointment of an external administrator to be the enforcement measure of last resort?

External administrators should only be appointed as a last resort measure.

Having regard to the answers given to the preceding questions: – Is any regulatory change necessary or desirable?

Membership of an ASIC approved EDR scheme should be mandatory for all providers of credit to Australian SMEs.

Is any change to the 2019 Code necessary or desirable?

Increase debt limit from less than $3 million to less than $5 million.

Should there be a national system for farm debt mediation?

There should be a national system that provides mediation for farm debt. This would help to provide consistency for the finance sector and certainty for those involved in agricultural business.

If so, what model should be adopted?

A new national scheme should be based on the NSW model.

Should lenders be required to offer farm debt mediation as soon as an agricultural loan is impaired (in the sense of being more than 90 days past due)?

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Lenders should be required to offer farm debt mediation when an agricultural loan is impaired. This would allow for a full and transparent exchange of information on items such as cost of holding the defaulted loan, prospects of rehabilitation, and timeframes until any rehabilitation. Most importantly, mediation keeps both parties communicating.

Section 10 – Issues that have emerged (pp. 327)

3 Small and medium enterprises (pp. 333)

Should there be any change to the legal framework governing small and medium enterprise (SME) lending?

CAFBA members do not believe that there should be any change to the legal framework governing SME lending. We believe that the current legislation provides for adequate protection of SME borrowers, but recognise that some minor clarification and enforcement of existing laws may be needed in response to the issues raised during the Commission.

CAFBA is concerned about the lack of universal EDR membership. EDR membership should be mandated to ensure that SME borrowers are protected. We also need to ensure that our regulators are active, diligent and well-resourced in order to address behaviour that does not meet standards set out in existing legislation. Governments must ensure that regulators and EDR schemes are provided with the resourcing required to support an understand the unique needs of the SME sector. Additionally, CAFBA members believe that there should be a clear and consistent industry protocol or standard to determine what is a third-party guarantor.

Should any lending to SMEs come within the reach of the National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act)?

CAFBA acknowledges that the National Consumer Credit Protection Act 2009 (NCCP) provides important protections to individuals who are taking out household and domestic finance. While the NCCP is appropriate for this setting, small businesses and SME lending is not impacted by the same problems in personal finance and the domestic residential mortgage sector.

CAFBA members believe that expanding NCCP to small businesses would adversely impact SMEs in Australia. SMEs are vital to our economy and need access to finance to survive. Expanding the NCCP to small business would increase the cost of and reduce access to loan finance. This view is shared by others in small business including, COSBOA, of which CAFBA is a member.

Expanding the NCCP could lead to the standardisation of processes which can close niche financial markets, leading to challenges for small businesses that do not 'fit the mould', particularly start-ups. In a nation which is seeking to promote innovation, regulation should not unnecessarily limit the availability of financial capital.

One of the key components of the NCCP is "responsible lending guidelines", which is a prescriptive set of standards under which a consumer's capacity to repay loans is assessed against their fixed income and expenses. The notion that a growing small business with variable income and costs can be assessed on the same basis as a fixed-income salary earner is fundamentally flawed. The application of NCCP-type lending principals on small businesses would be catastrophic for any business wishing to borrow for expansion, as their capacity to repay next year's commitments would be based solely on last year's figures without taking account of the purpose of the loan and the economic benefit that the deployment of extra capital would bring. The broader impact on economic growth and employment would be enormous. Appropriate regulation for businesses lies in fair contract terms and not in prescriptive lending guidelines.

The major risk of adopting wide-ranging reforms like expanding the NCCP is that it widens the regulatory burden that hangs over business finance and makes it more difficult to lend.

In 2018, CAFBA worked as a COSBOA member to contribute to the Reserve Bank of Australia (RBA) discussion on small business finance. The discussion heard that many small business owners continue to encounter difficulties in securing affordable lending products to support the growth of their businesses and to navigate short-term cashflow issues. Business owners who presented at the discussion highlighted that they had challenges with accessing the right financal products, limited knowledge of finance products, and substantial difficulty in navigating the associated red tape.

In 2014, CAFBA developed Professional Standards which have been reviewed and updated on a regular basis. All CAFBA members accept and abide by the professional standards. There are five core standards, covering: professionalism; duties to clients; business management; conflicts of interest; and member responsibilities. We have attached the Professional Standards document to this Submission for reference.

In summary, CAFBA members must: maintain a current knowledge of the law; demonstrate competence; provide independent and objective services; share any conflicts of interest with clients; ensure products are suitable; consider hardship; maintain membership of an EDR scheme; effectively manage their business by maintaining accurate records, manage risks, and comply with regulations; and above all, be honest, ethical, confidential, careful, efficient, prudent, and be fair in their conduct.

Ongoing improvement in delivery of outcomes for business owners seeking finance will be gained through maintaining professionalism in our sector. CAFBA has a strong commitment to building the professionalism of our sector in Australia. In 2014, CAFBA introduced a minimum education standard for its members, a Certificate IV in Finance and Mortgage Broking. Maintaining educational standards of our members is a core strategy of CAFBA. Our members are consistently provided with rigorous professional development opportunities and are kept abreast of changes to government policy in Australia. CAFBA has also worked to launch an accredited training program: Certificate IV in Financial Services; specialising in Commercial and Asset Finance (FNS41815). Over the past few years CAFBA has increasingly worked to share the experience of commercial and asset finance brokers in the United

States with our members in Australia. This has helped to strengthen our members ability to maintain a high-quality service in Australia.

3.1 Code of Banking Practice (pp.334)

CAFBA members believe that the Banking Code of Practice definition of small business is currently acceptable but requires two small amendments. Firstly, it would be prudent to state that there would be a review the $10 million annual turnover figure every five years. Secondly, the total debt amount allowable for a small business should be increased from less than $3 million to less than $5 million.

CAFBA believes that a diligent and prudent banking manager should assess character: the desire to repay the debt, cashflow: the ability to repay the debt through making payments, and capital: the ability to withstand unexpected negatives. We also maintain that the current legislation, regulatory frameworks, and industry codes provide diligent and prudent banking managers with the right tools to ensure they make the right inquiries. CAFBA believes that Clause 51 of the 2019 Code of Banking Practice (COBP) is sufficient to ensure an appropriate level of consideration. Analysis should always involve the analysis of character, cashflow, and capital.

3.2 Guarantees (pp. 334)

CAFBA believes that any potential guarantor should be fully aware of the financial agreement that they are signing up to and that they should be required to get legal advice before agreeing to participate." This should be reworded to reflect arms-length guarantors only, and not all guarantors. i.e. Family members who are not involved with the business. As the paragraph is currently written, it would be a nightmare for simple two-director companies if adopted, and it wouldn't reflect the collective view of our members.

7 Entities: Causes of misconduct (pp. 340)

7.4 Intermediaries (pp. 341)

CAFBA members have consistently demonstrated their professionalism. Intermediaries must act in the best interests of their clients and support them to gain access to improved lending options. Commercial and asset finance brokers in Australia have consistently demonstrated that they act with the best interests of their clients, supporting clients to navigate a complex financial system. Our members deliver on their duty to support their clients to gain the best possible solution to their lending needs. As stated above, commercial lending for SMEs is very different from household and domestic finance.

Our members are remunerated via a range of methods including trailing commissions that support the ongoing work required to maintain and service loans. This is to financially compensate the many hours that go into annually supporting the maintenance of each loan

for members clients. CAFBA's recent response to the NSW Governments Discussion Paper "Easy and Transparent Trading – Empowering Consumers and Small Business" covers our views on commissions and we have attached it to this Submission.

In summary, our submission to the NSW Government highlights that:

• SME credit is different to household/domestic credit;

• The hours of work that are provided by commercial brokers to their clients annually provides a genuine reason for trail income payments (work that is often required by virtue of APRA requirement APS 113);

• CAFBA broker members are required to belong to both an ASIC-approved External Dispute Resolution Scheme and the CAFBA Code of Conduct, and CAFBA supports ASIC's view that benefit can be derived when dealing with a lender, broker or intermediary that is a member of AFCA (Australian Financial Complaints Authority); and

• Transparency is important to consumers but so is choice. Governments must avoid overregulating to the point of limiting consumer options.

8 Restating the issues (pp. 343)

8.3 Responses (pp. 345)

Are changes in law necessary? Should carve outs and exceptions be reduced or eliminated? In particular, should point of sale exemptions to the NCCP Act be reduced or eliminated?

CAFBA strongly supports the elimination of the point of sale (POS) exemptions within the NCCP Act. CAFBA has made numerous submissions to government inquiries in relation to the POS exemptions and their negative impact on consumers. CAFBA members have been particularly eager to see the removal of the POS exemption for car retailers and other POS finance providers.

CAFBA recently provided a submission to the Productivity Commission Inquiry into Competition in the Australian Financial System. The PC's Final Report (29 June 2018) stated that Treasury should complete a review in POS exemption with a view to removing it.

Recommendation 15.2 Review of NCCP Act Exemptions states:

> *The Treasury should complete its 2013 review into the current exemption of retailers from the National Consumer Credit Protection Act 2009 (Cth), with a view to removing or reforming the exemption. The report should be made publicly available on completion. (pp. 433)*

The following is an extract from our second submission to the Productivity Commission Inquiry on the POS exemption:

"CAFBA has raised our concerns regarding the POS exemption to the Australian Government on various occasions (see attached list). We have met with representatives from ASIC on this matter who advised that they need a direction from Treasury to act on the POS exemption. ASIC has recently (2017) highlighted and taken action in relation to the provision of consumer finance through car dealerships. Our previous submission to the Productivity Commission in 2017 highlighted why this remains of significant concern to CAFBA members.

Prior to the commencement of the National Consumer Credit Protection Act in 2010, the Australian Government exempted point of sale (POS) vendor introducers from the requirements of the Act. The exemption thus applied to those who engage in credit activities at the point of sale. The specific exemptions included excluding those POS vendor introducers from the credit licensing regime and the responsible lending obligations. This exemption has remained in place for almost a decade and is an area of broken policy from the previous government that remains in need of repair.

CAFBA members, who are professional equipment finance brokers, are not exempt from the Act, and are bound by its rule when arranging finance for consumers, providing protection for consumers and sector-wide standards for brokers of consumer finance. This is something that CAFBA supports for the benefit of all, but in particular to ensure that consumers in Australia are protected.

The outcome is brokers of consumer finance fall into 2 broad classes; those who are required to be licensed and those who are not, simply because they are vendor introducers. In our view, a broad-based vendor exemption for consumer finance introduced at the point of sale is no longer tenable. It was intended to be an interim exemption for 12 months to allow the Government to consider the market and processes in greater detail. It is now approaching 9 years, and ongoing cases of consumer harm continue to emerge due to this legislative gap.

The negative consequences of POS exemption are that it provides an opportunity for high-risk consumer finance to be provided. The exemption opens a window of opportunity for inexperienced individuals with limited training to provide low-quality services to consumers. This is concerning.

Businesses providing financial services with a POS exemption:

• Are not required to meet any entry standards and ASIC is also unable to exclude vendor introducers from the credit market

• Can select, recommend or propose credit products without having to conduct an assessment as to whether the product is suitable for the consumer, or meets their financial requirements or objectives.

• Limit the ability of consumers to access remedies for the conduct of vendor introducers.

These characteristics are at odds with the requirements of finance brokers, such as many CAFBA members who are licensed to arrange consumer finance, complying with the Act and applying responsible lending practices. The alternative to licensing is for brokers to act

under the licence of a broker or a credit provider/lessor by being appointed its credit representative.

The exemption, therefore, does not provide any means of adequately regulating or controlling the activities of POS vendor introducers who may cause loss or damage to consumers, despite their linked credit providers/lessors being responsible for their conduct.

Consumers rely on their financial provider to give them a high-quality service when making any purchase. The variety of pressures placed on the staff of car retailers, combined with varying experience, or inexperience, in providing financial service can negatively impact on consumer experiences.

The risk of harm is more likely where the POS vendor introducer has selected the financier on the basis of the commissions they will receive if finance is approved, where those commissions increase the cost of finance paid by the consumer. The exemption also means that there is a lack of competitive neutrality between POS vendor introducers and other businesses, like licensed CAFBA members, which are performing similar functions.

How well-informed a consumer is about their car purchase and financial options should not depend on the practices of dealers involved. All dealers that are involved with providing finance options for car sales at the point of sale/ time of sale should be experienced professionals and be trained in providing services specific to their client’s needs.

Of concern to CAFBA is the way some consumers may misunderstand the protections available to them when accepting finance from POS vendors. Car buyers may believe that they have full protections when they obtain dealer finance and, through a lack of awareness of POS policy and legislation, they place unwarranted faith in what they are told by car dealers which make them even more vulnerable than the exemption itself and even easier prey for unscrupulous operators.

The Competition and Consumer Act (CCA) promotes competition and fair-trade markets to benefit consumers, businesses, and the community. CAFBA holds the strong view the current vendor introducer exemption to the NCCP Act is at odds with objectives of the CCA. Conduct by businesses in an Australian market is meant to be such that does not have a substantially adverse impact on competition or detriment to the broader consumer interest. The only occasions on which conduct should run counter to this is if the law believes it is the public interest to do so. The ACCC, the Australian Competition Tribunal and the courts are arbiters of the public interest.

CAFBA understand specific laws, such the POS vendor introducer exemption can override the essential tenets of the CCA. Despite this, the continuation of that exemption cannot be sustained in the public interest. The anti-competitive effect of continuing the exemption is the significant financial and compliance investment by licensed brokers in meeting their licensing and responsible lending obligations and in maintaining them over the longer term.

By comparison, POS vendor introducers merely have to follow what their linked credit providers /lessors train them in and instruct them to do. There is no investment in POS standards, consumer protection or consumer disclosure. And, at its worst, the structural

issues can result in a significant disadvantage by consumers paying more for their finance than they may have otherwise, resulting in potentially a significant financial benefit to the POS vendor introducer.

The anti-competitive consequences of the current POS vendor introducer exemption are very real to the consumer finance broker market. It is, to our mind, bad public and competition policy to have different regulatory models and outcomes for the same processes/ services unless it is demonstrably in the public interest to do so. CAFBA does not see competition law public benefit in keeping the current POS vendor introducer exemption."