Regulation Impact Statement: Small business credit

This Regulatory Impact Statement (RIS) considers whether credit provided to small business should be regulated, as part of the National Credit Reforms.

Executive Summary

The provision of credit to small businesses can assist them to meet their start up, expansion or ongoing business cost requirements. A review of the sector suggests that the majority of small business lenders and brokers operate in a way that provides a valuable service to their borrowers. However, some practices exist in the industry that can result in high levels of financial losses to individual small business borrowers.

These practices primarily occur in relation to 'distressed' small business borrowers, that is, borrowers who are in a position where they are seeking funds urgently to keep their business afloat (rather than, for example, wanting credit to expand their business). The most common scenario is where the business has defaulted in the repayments under an existing loan, and that lender has either commenced enforcement action or is threatening to do so.

The current legislative framework does not adequately address these practices. The possibility of enforcement activity by the Australian Securities and Investments Commission (ASIC) that would comprehensively address is subject to limitations including a combination of regulatory and enforcement gaps and the prohibitive cost and inefficiency of enforcement action. There are also substantial barriers to recovering compensable losses, both in actions taken by ASIC and by consumers in their own right.

It is recognised that small businesses cannot be absolved of all responsibility for their financial and business decisions, and a balance should be reached between protecting the most vulnerable and allowing the market to price risk. To achieve this balance, it is proposed to introduce targeted regulation which will minimise as far as possible the impact on lenders who are not engaging in these practices.

Targeted regulation would be introduced through a negative licensing scheme, improved disclosure requirements, universal access to external dispute resolution (EDR) and the introduction of a remedy for asset-stripping conduct. This approach is influenced by the extent to which lenders and brokers are largely already members of an EDR scheme and also hold an Australian credit licence (limiting the impact on these persons). Were this not the case a different approach would need to be considered.

These reforms will improve ASIC's supervision and enforcement ability and give ASIC the ability to exclude entities from the market in the event of severe misconduct. They will also assist consumers by giving them access to more affordable dispute resolution, and result in improved understanding of the loan contract in some cases.

The reforms are not expected to comprehensively address this type of misconduct in the small business lending market, but are expected to have a deterrent effect on some lenders. Borrowers will have improved access to compensation if misconduct occurs, and ASIC will have improved ability to identify and exclude lenders where, for example, they demonstrate a continued reluctance to comply with the law.

It is difficult to quantify the cost to industry and the benefits to borrowers (and there is difficulty in observing and quantifying any flow on consequences), and it is not possible to state definitively whether or not this reform would have a net benefit in monetary terms. Costs to all small business lenders will include one off implementation costs to change disclosure procedures and modify other practices to address regulatory risk. Most lenders would not need to make substantial changes as they are already complying with, or are in a position to readily comply with the reforms. Nevertheless, the reforms propose addressing this conduct in a way that may have impacts on all borrowers, primarily through the risk of higher costs or some lenders exiting the market.

Overall, it is considered the reforms balance the need to protect borrowers while minimising as far as possible the costs to industry, and have the potential to reduce significant losses to individual businesses.

Context

Introduction

In this section of the RIS the statistics in relation to small businesses are based on the definition of a small business employed by the Australian Bureau of Statistics, that is, an actively trading business with between one and 19 employees. However, data in relation to loans is based on credit under $2 million, with the size of the loan used as a proxy for the size of the business (although it should be noted that loans of this amount will include some advances to businesses that employ more than 19 persons).

Small Business Credit Market in Australia

Recent statistics indicate that:

- as at June 2009, there were approximately 1.9 million small businesses (with the majority being unincorporated)[1];
- in 2009-10 small businesses employed almost 4.8 million people[2];
- in 2009-10 small businesses contributed over a third of the contribution by all industries to Australia's gross domestic product[3]; and

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1 Department of Innovation, Industry, Science and Research, Key Statistics Australian Small Business, 2011, p. 8.
2 Australian Bureau of Statistics, Cat. No. 8155.0.

- as at December 2011, small businesses had over $200 billion outstanding in loans.

The main sources of finance for small businesses are:

- banks;
- ADIs other than banks;
- non-ADI lenders, other than private lenders; and
- private lenders

Lending by Banks

The majority of lending to small business is provided by banks. Data from the Reserve Bank of Australia for December 2011 shows that the value of outstanding bank business loans for amounts under $2 million, was $201.8 billion[4], with the four major banks accounting for 86 per cent of total lending for business loans under $2 million.

The characteristics of lending by banks to small businesses are:

- they operate on relatively low profit margins;
- lending decisions are generally tightly controlled with limited flexibility relative to other lenders, often with detailed and paper-based assessment procedures; and
- subsequent to the 2008 Global Financial Crisis, banks have become more selective in determining eligibility. Some banks are reducing their exposure to commercial borrowers and commercial property risk, and lowering acceptable loan to valuation ratios to minimise their credit exposure.

Non-Bank ADIs

Non-Bank ADIs comprise credit unions and building societies. Some credit unions and building societies provide low volumes of business credit. They have a limited capacity to engage in small business lending, as their core business is lending for residential properties. They are conservative in approach and traditionally prefer residential assets as security, with additional requirements in relation to, for example, location of those assets.

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3 Australian Bureau of Statistics, Cat. No. 8155.0

4 http://www.rba.gov.au/statistics/tables/xls/d08hist.xls?accessed=2003-12:15:08 This lending will include an unknown amount of loans provided to businesses that do not fall within the definition of a small business.

Other non-ADI Lenders

Lenders in this group include a range of entities that raise funds from third parties, including managed investment schemes, unit funds, finance companies and registrable financial corporations (that is, lenders with assets over $50 million that are required to report to the Australian Prudential Regulation Authority under the *Financial Sector (Collection of Data) Act 2001*). They vary in size from companies that manage tens of millions of dollars to those that manage billions. Some are publicly listed although the majority are unlisted.

Most lenders in this category raise funds from wholesale or retail investors and pay a fixed rate of return. Their costs of capital therefore vary according to the promised rate of return. They may also securitize, when the market is receptive. They are often specialists who departmentalize according to asset classes, which provides for a higher degree of credit autonomy within those classes.

Private Lenders

A number of private lenders operate in Australia, ranging from single, wealthy investors, to private company funds. Typically loans are provided through mortgage managers that administer loans on behalf of a number of funds, non-ADI finance companies and individuals.

Most private lenders have limited access to capital and their credit decisions and rates of interest are dictated by this. They tend to occupy the risk areas where the highest return for a manageable risk can be attained. This results in a concentration of business in short-term and bridging finance, where attractive returns can be achieved within relatively short timeframes (with loan terms generally ranging from between one to two month loans to twelve months, but in some cases up to 24 months). Lenders with less than $5 million under management will be largely equity funded. Lenders with greater than $20 million under management have increased funding options, which could include wholesale facilities from a bank.

Private lender business models tend to be characterised by a high degree of autonomy in credit decisions by staff, potentially providing them with greater flexibility in providing credit. They may also pay relatively high commissions to brokers in order to obtain access to distribution channels.

Role of third parties

Small business borrowers have increasingly used brokers to assist them with arranging credit contracts. A recent report by Fujitsu Australian on the SME Market found that approximately only 21 per cent of micro and small business loans are broker originated[5].

Broking for small business lending can be more complex than lending for personal use. This is due to a number of reasons, including a broader and more complex range of credit products

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[5] http://www.fujitsu.com/downloads/AU/sme_report_vol1.pdf

that may meet the borrower's needs, the need for detailed financial information requirements, restricted timeframes in which to complete transactions, the ongoing and fluid nature of the relationship between the lender and the borrower, and the consequential need for continuing contact between the borrower and the broker.

The other principal source of advice for small business borrowers is accountants, who may engage in a range of conduct in relation to small business credit, including preparing loan applications, providing advice in relation to credit options, negotiating the terms and cost of credit directly with the credit provider, and helping the borrower to meet regular business reporting requirements to their credit provider.

Regulatory Framework

Introduction

Lending to small business is subject to a combination of legislation and self-regulation as follows:

- Commonwealth and State statutes impose a range of specific and limited legal obligations; and

- some industry bodies have introduced self-regulatory codes that apply to their members.

Legislation

There is no comprehensive regulation of lending to small businesses. The *National Consumer Credit Protection Act 2009* (Credit Act) only covers credit that is provided to natural persons or strata corporations, and for the purpose of personal, domestic or household use, and therefore does not apply to small business lending.

Lending to small business is regulated by legislation as follows:

- High level prohibitions.

  The *Australian Securities and Investments Commission Act 2001* (ASIC Act) has a broad jurisdiction over the provision of credit to small business and consumers and advice and broking conduct in relation to such credit. The ASIC Act covers broad standards of conduct, including prohibitions on unconscionable conduct, misleading or deceptive conduct and the making of false and misleading representations. There are counterpart provisions in force under State laws.

- Regulation of hire-purchase transactions.

  The States have a range of Hire Purchase Acts, with different levels of coverage in individual States and Territories. In Queensland, Victoria and Western Australia, hire purchase legislation applies to transactions for farmers and small business transactions that fall outside the credit legislation. In the ACT, New South Wales and South

Australia, hire purchase transactions are subject to general credit laws. They are regulated by specific legislation. Tasmania and the Northern Territory have regulations in place for hire purchase arrangements for both consumer and commercial purposes.

- Sector-specific regulation in relation to some farming contracts.

  The *Queensland (Rural Finance) Act 1996* (Qld) enables a farmer to seek a moratorium of up to 12 months before farm machinery can be repossessed by a mortgagee. The *Farm Debt Mediation Act 1994* (NSW) provides a mechanism for farmers to request compulsory mediation after they have been given notice of intended enforcement action.

It is noted that intermediaries arranging credit for small businesses in Western Australia were previously required to comply with the *Finance Brokers Control Act 1975 (WA)* and the *Finance Brokers Control (Code of Conduct) Regulations 2007*, as this legislation was not limited to credit regulated by the Uniform Consumer Credit Codes. The transfer of responsibility to the Commonwealth has resulted in the repeal of that legislation, with a consequent reduction in the level of regulation of intermediaries in that State in this respect.

Obligations under Codes of Conduct

Some industry bodies have developed codes of practice that their members can agree to comply with, usually as a condition of membership, so that they must become signatories to the Code in order to receive other benefits (such as access to professional indemnity insurance arranged by the industry body).

These Codes may provide small businesses with contractual rights and may also provide them with an ability to resolve disputes through complaint to an external dispute resolution scheme (EDR scheme).

The following Codes are in operation:

- the Code of Banking Practice;
- the Mortgage and Finance Association of Australia (MFAA) Code of Practice;
- the Mutual Banking Code of Practice; and
- the Finance Brokers Association of Australia (FBAA) Code of Practice.

In general terms these Codes provide small business borrowers with some additional rights in relation to matters such as:

- pre-contractual disclosure requirements;
- obligations in relation to assessing the suitability of credit for the consumer;
- a positive commitment to assisting borrowers in financial hardship; and

- mandatory membership by members of an ASIC-approved EDR scheme.

Complaints Resolution

Small businesses have two main options for resolving complaints, legal action or complaint to an EDR scheme, provided that the lender or broker the subject of the complaint is a member of such a scheme.

The majority of lenders or brokers operating in the small business market are already members of an EDR scheme, primarily because they hold an Australian credit licence (ACL) and EDR membership is a condition of holding a licence. A number of other lenders and brokers have elected to become members as a result of being a signatory to a code of conduct developed by their industry body.

Small businesses will be able to have complaints against the majority of lenders or brokers considered by an EDR scheme, and therefore potentially resolved without court action. The main classes of lenders and brokers who are currently not members of an EDR scheme are:

- Specialised lenders and brokers who only engage in small business lending, and do not hold an ACL (and are therefore not required to be members of an EDR scheme). This would mainly include smaller lenders.

- Accountants, who regularly provide advice to small businesses in relation to finance options.

It is noted that an EDR scheme may be unable to determine a complaint by a small business where the complaint is not covered by their terms of reference. The main grounds where resolution would not be possible are:

- Where the amount in dispute exceeds the monetary threshold (given that small business lending may involve amounts higher than consumer lending).

  – The Financial Ombudsman Service (FOS) and the Consumer Ombudsman Service Ltd (COSL) can both consider claims up to $500,000. However, the maximum amount of any award of compensation is $280,000 for FOS, and $250,000 for COSL; that is, the complainant must agree to accept compensation not exceeding $250,000 even if they would otherwise be entitled to more.[6]

- Where the dispute is in relation to matters of commercial judgement (such as a refusal to provide credit).

[6] Clauses 9.1 and 9.2, definitions 44.1 in COSL Rules (March 2010 version). The monetary compensation limit will increase to $280,000 on and from 1 January 2012 and will be adjusted thereafter every three years using the higher of the increase in the MTAWE or CPI (COSL Member Alert, 8 September 2009).

Problems experienced by small businesses

Conduct in relation to distressed borrowers

Treasury has identified three practices engaged in by lenders and brokers, in relation to small business borrowers who are in financial distress (with two of the practices similar to 'equity stripping' practices engaged in by some home loan lenders)[7]. The lenders and brokers who engage in these practices are called 'fringe lenders and brokers' in this section of the RIS.

The intention of these lenders and brokers is to have the small business enter into a transaction that is unfair in that it does not provide the borrower with the benefits they anticipated when they entered into it, but is intended by the lender or broker to result in the accelerated transfer of wealth (principally in the form of equity in a family home) from the small business borrower. The transfer of wealth is accelerated relative to a mainstream transaction in that either the return on the loan is generated through default by the borrower (rather than repayment over time according to its terms) or through charging brokerage or application fees irrespective of whether or not credit is to be provided (so that payment does not depend on a loan being entered into).

There are a range of factors that contribute to why small business borrowers may enter into contracts with these persons, ranging, for example, from poor decision-making to a lack of understanding of both the short-term and long-term implications of the transaction. These reasons are explored in more detail below under 'Motivations of borrowers'.

Their target market is distressed small business borrowers, that is, borrowers who are in a position where they are seeking funds urgently to keep their business afloat (rather than, for example, wanting credit to expand their business). The most common scenario is where the business has defaulted in the repayments under an existing loan, and that lender has either commenced enforcement action or is threatening to do so.

As a result of this financial stress the products being offered present different and greater risks to these borrowers than credit contracts provided in other circumstances. The principal such risk is that almost invariably borrowers will be unable to exit from the product by refinancing, reducing their options for mitigating the financial losses resulting from the product.

These lenders and brokers use a range of techniques to market themselves to distressed small businesses:

- The primary method is to use existing broker channels, and to pay commissions at rates or in circumstances that encourage referrals. In particular, these fringe lenders attract potential borrowers by paying a commission to brokers, including a commission

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[7] The operation of equity stripping practices in the consumer lending space is discussed in detail in the Problem Identification section of the Regulation Impact Statement prepared by the Commonwealth Treasury, *Addressing Avoidance of the National Consumer Credit Protection Act 2009*.

irrespective of whether or not a loan is approved. Payment of a commission irrespective of whether or not a loan is approved encourages brokers to forward applications in respect of clients where they would be otherwise unable to arrange a loan (or therefore earn a commission).

- They also use advertising and promotion on the basis they can provide a specialist service to assist distressed small business borrowers. The development of the internet allows their services to be offered more broadly, and not be limited by geography.

The three practices operate as follows:

1. The first practice is a form of equity stripping.

   1.1. The lender provides credit to a small business that is in financial distress. The term of the loan is relatively short (for example, one to three months), and it is typically secured over a residence of the borrower or a relative.

   1.2. There is no exit strategy at the end of this period, or identifiable or verifiable benefit to the borrower. Alternatively, the exit strategy depends on the sale of the property, but the period of the loan is inconsistent with the usual period for a sale of the property at a reasonable price. This can be compared with bridging finance that is on terms that, for example, allow for a manageable wind down of the business by linking the term of the contract to an end point that is consistent with the borrower's strategy.

   1.3. Repayments are typically capitalised into the amount borrowed, so that the loan is attractive to the borrower from this point of view. The cost and repayments are set at a level that the borrower is in effect 'priced into risk', so that the likelihood of defaulting is significantly increased or, in the most extreme cases, made almost inevitable.

   1.4. The borrower is unable to refinance with a third party at the end of the loan term or to discharge the debt, as their property has not been sold, and therefore becomes liable for high default charges and other costs.

   1.5. The lender may then:

      1.5.1. agree to defer sale of the property on the condition the borrower enters into another loan contract (which can be on more onerous terms that erode their equity at a greater rate); or

      1.5.2. sell the property.

2. The second practice is known within the industry as 'fee farming'.

   2.1. The lender solicits applications for finance from distressed borrowers (including through brokers). As soon as the lender receives an application (from a small

business borrower) it sends out an offer letter to be signed by the applicant. The applicant is asked to sign and return the letter of offer as soon as possible.

2.2. The offer letter is sent out prior to any inquiries to assess whether or not the borrower is likely to be eligible for a loan. The lender will ensure that the borrower has equity, but will not enquire as to whether the borrower has any capacity to repay the loan.

2.3. The offer letter includes a list of detailed fees payable irrespective of whether a loan is provided or not, and therefore disproportionate to the level of work or inquiry that may be required in order to decide whether or not to approve the loan.

2.4. The letter includes a charging clause over property of the small business owner or a relative or spouse, and enables the lender to charge fees irrespective of whether or not a loan is provided (with the level of fees both high and not reflecting the time and costs incurred in deciding whether or not to approve the loan).

2.5. The borrower is placed in a position where either:

2.5.1. the borrower's application is often rejected by the lender (as the borrower was never likely to be eligible for a loan), but the borrower is still liable to pay significant fees; or

2.5.2. should a loan be offered by the lender, they have no practical choice but to agree to it, irrespective of the terms on which it is offered, because of the costs and time they would incur in disputing the caveat (where it may result in an equity stripping loan as discussed above).

3. The third practice is a version of asset stripping that relies on a default by the borrower other than in relation to a failure to make repayments.

3.1. The lender actively solicits applications for credit from businesses that are distressed, but where sufficient equity is available, with finance secured by way of a mortgage. Brokers may direct borrowers to such a lender.

3.2. Once credit is provided the lender asserts that the borrower is in default under the mortgage. The default is technical rather than substantive in that it does not relate to capacity to make repayments or that seriously compromise the interests of the lender (for example, because the insurance cover is inadequate). Often this claim has no merit, but the borrower will incur significant costs and delay should they wish to dispute the claim (and would generally therefore not be in a financial position to do so).

3.3. The lender relies on these defaults to:

3.3.1. install a receiver, place the business in administration and to thereby obtain control of its bank accounts and cash flow, and to threaten a fire sale of the assets of the business; and

3.3.2. demand payment of significant charges in relation to the default, as well as seeking repayment of the loan, plus interest at a default rate.

3.4. The lender is able to obtain full payment of the sum claimed:

3.4.1. by selling the assets; or

3.4.2. by obtaining a settlement under which the borrower agrees to enter into a second loan to repay their existing liability plus a high level of costs.

3.5. The outcome for the borrower is that:

3.5.1. they have both no financial capacity and no management capacity to dispute the lender's claims through court action; and

3.5.2. the level of their debt can be inflated by a range of costs consequent on the alleged default within a short period of taking out the loan (for example, the size of the debt claimed by the lender can nearly double within a period of 4 months).

The following Table summarises the differences between the conduct of fringe and mainstream lenders and brokers in relation to each of these practices

Table 1 Comparison of lending and broking practices

Practice	*Fringe lenders and brokers*	*Mainstream lenders and brokers*
Equity stripping	No exit strategy determined with borrower prior to entering into contract (so that, for example, the period of the credit contract does not provide a reasonable period for the sale of the borrower's property, allowing a reasonable sale price to be achieved).	Exit strategy determined with borrower prior to them entering into contract. Where the loan is to be repaid from the sale proceeds of a property, the lender ensures there is a known settlement date or that the terms of the contract are consistent with reasonable expectations in relation to both the sale price and the anticipated sale period.
	Contract is provided irrespective of whether or not it meets the borrower's long-term needs (for example, the lender offers credit where the borrower is under the misapprehension they will be able to refinance to a long term home loan rather than having to sell the property ultimately in any event).	The cost benefit of the transaction is assessed prior to the borrower entering into the contract.
	For longer terms loans (for example,	If the exit strategy for the loan is to

Practice	*Fringe lenders and brokers*	*Mainstream lenders and brokers*
	for 12 months) fees and interest are charged at levels that make it impossible for the borrower to refinance (because the reduction in equity will make the borrower ineligible for a refinance with mainstream lenders with more conservative loan to valuation ratios).	refinance after 12 months, fees and interest are charged at levels that allow for this.
Fee farming	A letter of offer to arrange finance is sent to the borrower before there has been any consideration of the viability of the application, or whether the borrower may ultimately be eligible for the loan.	The borrower is usually not required to sign a letter of offer until there has been some preliminary consideration of the application.
	The costs are significantly disproportionate to the cost of the work that would be undertaken by the lender in assessing the eligibility of the borrower, and may be based on the level of equity available in the borrower's property.	The costs are consistent with those charged to borrowers who are not in financial distress, and are therefore competitive.
Asset stripping through non-repayment defaults	The lender relies on technical defaults under the contract shortly after the contract has been entered into.	The lender would protect itself against risk of financial loss by making inquiries prior to entering into the credit contract.
	The lender threatens or commences enforcement proceedings in reliance on technical defaults.	The lender would only treat substantive non-compliance as a default warranting enforcement action (for example, a failure to have any insurance cover rather than have inadequate insurance cover).
	The lender claims substantial costs from the borrower as a result of the default, and then demands payment of lump sums that borrower cannot afford to pay, rather than repayments.	The lender minimises default costs, allowing for possibility that these can be met from borrower's resources or by minor variation to payments under the credit contract.

This Table illustrates the contrast between predatory and responsible lending and broking practices, and the different outcomes for small businesses. The outcomes for these businesses from dealing with fringe lenders and brokers would be as follows:

- *Equity stripping:* Some small businesses may receive a benefit from the provision of credit where it allows them to continue trading, notwithstanding the cost of the transaction. In other words, the failure by the lender to identify any exit strategy or

assess capacity to repay (when the term of the loan expires) creates a significant risk that the borrower will ultimately default when they are required to repay the loan in full, but whether default actually occurs will depend on a range of factors such as the overall financial position of the business, and the ability of the borrower to negotiate alternative sources of credit. The extent to which this may occur is not possible to quantify.

  – An indication of the financial losses small businesses may suffer is provided by ASIC's 2006 report, *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress*. The report reviewed equity stripping practices in relation to consumer borrowing for personal use. However the underlying practices are similar. The report analysed three refinances in detail. It found that for these borrowers, the refinance cost them on average 27 per cent of the equity they had accumulated in their home, and a minimum of $20,120 in fees and charges (excluding interest charges).

- *Fee farming:* This will always result in adverse outcomes for small businesses in that they incur a liability (to pay brokerage fees) without having received any benefit. They experience a further disadvantage in that the erosion of their equity (through the contractual obligation to pay the fee) will reduce their capacity to obtain alternative finance (as the lending to valuation ratio for a future lender will be higher than would be the case prior to payment of the fee).

- *Asset stripping through non-repayment defaults:* This will always result in adverse outcomes for borrowers as the model is based on matters within the control of the lender (enforcing onerous penalty clauses in the credit contract). Unlike the equity-stripping problem it is not based in a default in repayments which ultimately may not occur. The level of detriment the small business borrower will experience is limited in practice only by the amount of equity in their property.

As this analysis illustrates, the consequences of these practices are significant for individual small business borrowers as they result in non-productive transfer of wealth in their assets to the lender or broker. It also has downstream effects for small businesses from the loss of equity that can include economic and social costs associated with relocation, and loss of the opportunity to generate greater personal wealth through home ownership.

The alternative conduct that would be engaged in by mainstream lenders and brokers would result in these borrowers being able them to cease trading and pay their creditors without incurring the same level of debt to the lender, or by retaining a greater amount of equity in their home. The amount of the financial harm suffered by the small business borrower in dollar terms will vary from case to case, depending on their facts and will be primarily determined by their level of equity in any property.

The extent of these practices is unknown, primarily due to a lack of any reporting requirements.

While it is not possible to estimate the extent of this activity, it is considered that:

- Existing fringe players who have engaged in these practices on a systemic basis over a number of years have developed increasingly sophisticated methods of targeting small business borrowers, primarily by increasing their reach through the number of brokers who will provide them with referrals.
- The number of persons engaging in these activities has increased in the last few years. A number of different industry players have advised that, following the introduction of the licensing requirement in relation to credit for personal use, some players have simply transferred their equity-stripping business models from the regulated space to the unregulated space, increasing the number of players engaging in these practices.

A further indication of the extent of these practices is provided by data published by the Insolvency and Trustee Services Australia, based on a survey it conducts of unincorporated sole traders. One of the survey questions asks respondents to self-identify the reason they became insolvent. Sole traders stated that that they became bankrupt or insolvent, or entered into debt agreements because they were charged ‘excessive interest payments’ on loan monies in between 4 to 7 per cent of cases (as set out in Table 2 below).

The significance of this response is that it indicates that sole traders are labelling the interest payments they were charged as excessive with the benefit of hindsight, as they presumably did not consider they were excessive when they entered into these contracts.

Table 2 Percentage of bankruptcies, debt agreements and insolvencies due to excessive interest payments

Year	*Bankruptcies*	*Debt agreements*	*Personal insolvency agreements*
2007-2008	318 (7.0%)	20 (9.0%)	4 (3.0%)
2008-2009	245 (6.0%)	30 (8.0%)	5 (2.0%)
2009-2010	194 (4.0%)	60 (12.0%)	5 (2.0%)
2010-2011	310 (5.6%)	27 (5.0%)	8 (5.1%)

Source: Annual Reports by the Inspector-General on the Bankruptcy Act 1966

The following qualifications apply in relation to this data:

- It only covers small businesses that became bankrupt or insolvent, or entered into debt agreements. The nature of the predatory lending activities referred to in this RIS suggests that small businesses are being targeted that have enough assets to cover their debt (so that bankruptcy or insolvency may not necessarily be the outcome of these practices).
- The reference to excessive interest payments may not solely refer to predatory lending, but would cover other situations where the small business is unable to service their debt.

Limitations in Existing Regulatory Arrangements

There are a number of reasons why the existing regulatory arrangements are inadequate to either prevent the predatory practices identified above, or to compensate consumers where they have suffered losses as a result of them. These reasons are:

- The conduct engaged in by fringe lenders and brokers does not infringe the ASIC Act in some circumstances;
- The prohibitions in the ASIC Act will only be effective in preventing the conduct to the extent they deter lenders and brokers from engaging in conduct in breach of the prohibitions, which is insufficient; and
- There are practical limitations that restrict the capacity of borrowers to obtain compensation where they have suffered losses.

Conduct May Not Infringe the ASIC Act

The analysis of the practices in Table 1 identified in relation to distressed borrowers indicates that lenders and brokers engage in the following classes of conduct:

- Equity stripping:
  - The lender provides a contract on terms that are inconsistent with the borrower's expectations (as the borrower may expect to be able to refinance at the end of the loan term, but without the lender having encouraged this expectation or misleading the borrower as to the outcome).
  - The lender enters into the contract without assessing the borrower's capacity to meet repayments at the end of the term of loan.
- Fee farming:
  - There is a significant disparity between the costs charged and the services provided.
  - The lender provides contract on terms that are inconsistent with borrower's expectations but as stated in the letter of offer (as the borrower does not expect fee to be payable even where no loan is provided, again without the lender having encouraged this expectation or misleading the borrower as to the outcome).
- Asset stripping through non-repayment defaults:
  - There is reliance on terms of the contract in relation to default clauses in ways that would not be reasonably expected by the borrower.

Courts have interpreted the ASIC Act prohibitions (in relation to conduct that is misleading or deceptive, unconscionable conduct or the making of misrepresentations) in a way that almost invariably means there is no remedy to consumers for losses resulting from these

types of conduct. This approach reflects that the prohibitions are intended to cover a broad range of situations, and that therefore they operate to address the most extreme classes of conduct in all cases. They do not, and are not intended to provide, nuanced remedies to address other more limited situations where regulatory intervention is warranted.

In particular the courts' approach has been:

- To enforce contracts according to their terms (including default clauses), notwithstanding that there may be unequal bargaining power between a small business borrower and a lender. For example, unconscionable lending requires the complainant to establish that they were under a special disadvantage, and that unequal bargaining power between two parties to a commercial contract will not constitute a special disadvantage (although it may be a disadvantage).

- To not introduce any universal duty on lenders and brokers to either verify statements by the borrower as to their current or expected income, or to provide or arrange loans where the consumer can afford to meet the repayments.

  – However, a lender is at risk of being found to have acted unconscionably where they were on notice the borrower may default. This approach can encourage lenders not to make inquiries into the borrower's capacity to make repayments in order to avoid this outcome. Where the lender is on notice the risk that they will be perceived to be taking advantage of the borrower's desperation increases.

- To not find that a contract is unconscionable or otherwise in breach of the ASIC Act where the dispute or claim is based on an argument that the cost charged for fees or products represents value for money.

Additionally fringe lenders and brokers are generally able to obtain access to legal advice about the way the ASIC Act is currently interpreted by the courts. As a result they are able to construct the transaction and document it in a way that increases the difficulty (to the borrower or to ASIC) of establishing the conduct is unconscionable or misleading or deceptive.

Finally, the onus of proof is on the complainant, that is, the borrower. There are often evidentiary difficulties where the case relies on resolving competing versions of facts as to what was and was not said by the parties and how these things should reasonably been interpreted in the circumstances.

Deterrence Effect of Prohibitions

Even where ASIC is able to successfully prosecute court action under the ASIC Act this only has a limited impact in relation to deterring this conduct more generally. The reasons why the deterrent impact of increased enforcement action by ASIC would be limited are:

- Lenders can manage the risk of unfavourable precedents by settling such cases (even on the basis they pay some compensation) rather than have them proceed to hearing. They can thereby ensure the continued long-term productivity of their business models by

taking a risk management approach to individual cases that may threaten those practices.

- A decision in relation to one particular provider or class of conduct is likely to be limited to a particular set of facts (given the reluctance of the courts to make findings imposing general or universal duties or obligations as set out above). Other providers may therefore be able to make minor changes to their practices, on the basis of legal advice, to avoid falling within the scope of any precedent.

- To the extent a decision in one case may cover other providers they may simply elect to continue engaging in that conduct unless and until ASIC begins an investigation into their activities. This decision may be more likely where the provider considers the prospects that their activities will come to ASIC's attention are low or remote.

Given these factors it would be necessary for ASIC to undertake enforcement activity on a very large scale (covering a number of providers) in order to comprehensively address this type of conduct. This would be prohibitively expensive and an inefficient use of ASIC's resources given the other demands on their resources and the potential limitations or uncertainties as to outcomes.

Limited Capacity of Borrowers to Obtain Compensation

Where a borrower has an arguable or even a prima facie entitlement to a remedy, there are practical obstacles that limit their capacity to obtain a remedy. By definition distressed borrowers are in financial difficulties and almost invariably will be seeking compensation as a result of having incurred losses (for example, after their home has been sold).

The lenders and brokers engaging in this misconduct commonly structure their operations in a way that means they do not provide credit for personal use, and they therefore are not required to be a member of an EDR scheme (as would be the case if they held an ACL). In the absence of such membership the borrower can only seek recourse through court action. However, their financial position will have deteriorated as a result of the losses incurred to a level where it is extremely unlikely they will be able to afford the significant costs required to pursue litigation.

ASIC has capacity, under the ASIC Act, to commence action and seek compensation on behalf of a number of consumers. In practice, this option is subject to similar restrictions to those outlined in the previous section.

Motivations of fringe players

Fringe players who engage in this conduct are able to make significant financial returns in a relatively straightforward and risk-free way, for the following reasons:

- They do not require a substantial investment of capital, in that, either no loans are provided or the loans are provided on the basis that they will be repaid, under the terms of the contract, within a relatively short period of time. This means that the level of

finance required is small enough to be only a minor barrier to persons participating in this conduct.

- This in turn means that fringe lenders do not need to raise substantial funds from third parties. There is therefore an absence of any control or compliance obligations from the ultimate providers of capital or any need to satisfy third party due diligence and other requirements as to how the business is conducted.

- There is a minimal risk of the fringe player themselves suffering financial loss in these transactions, as they are either not advancing money or only doing so where there is sufficient equity in real property to ensure repayment of the debt.

- There are no barriers that prevent or impede these businesses from attracting potential borrowers. First, the nature of small businesses means there will always be a percentage of businesses facing imminent failure (that is, while the business model does not depend on attracting repeat customers this is not an impediment to it continuing to operate). Secondly, these fringe lenders and brokers are able to attract these businesses by niche advertising and by paying a commission to brokers, including a commission irrespective of whether or not a loan is approved.

  – Payment of a commission irrespective of whether or not a loan is approved encourages brokers to forward applications in respect of clients where they would be otherwise unable to arrange a loan (or therefore earn a commission).

Motivations of borrowers

This section of the RIS considers the reasons why small business borrowers are susceptible to entering into high-risk transactions with predatory lenders that provide them little practical benefit.

There are a range of factors that inhibit sensible or more rational decision-making. These factors can be innate, internal to the business or external, as follows:

- ***Innate*** refers to the characteristics, background and education of the borrower. This group comprises individuals who would be at the lower end of the spectrum in relation to financial literacy, and consequently they would display poor levels of understanding and judgement in relation to business matters generally.

- ***Internal factors*** refers to matters relating to the operation of the business which can hinder good decision-making. The main such circumstance in relation to distressed small business borrowers is that they are under financial pressure, and may be threatened with or already confronted with legal action by an existing lender.

  – This means the borrower is required to make decisions quickly, while they are under emotional and financial stress, and often without the time or money to seek external advice. All of these factors can adversely affect the quality of the decisions being made.

– It also means that the borrower may only, or primarily, consider the transaction on the basis of an assumption that they will operate as they expect. The circumstances in which financial loss arise in contexts not intended or anticipated by the borrower (and therefore unlikely to be considered to the same extent). These circumstances are:

  : in the case of fee farming – the borrower's expectation is that finance will be provided, or that if it is not provided they will not be charged fees they can only pay by selling their home; and

  : in the case of equity stripping activities – the borrower may not appreciate that they are likely to fail to comply with the contract by repaying the lump sum owing at the end of the contract, or that the lender can earn more where this is the case, than if they were to make all the repayments due under the contract.

- ***External factors*** refers to conduct of the fringe lenders and brokers that inhibits the capacity of the small business borrower to understand the nature of the transaction. This can include conduct such as requiring borrowers to sign complex and lengthy documentation while providing them with only limited time to decide whether or not to accept the proposal or obtaining the confidence of the borrower by presenting the transaction as a solution to their financial problems (so that the borrower is less likely to question the transaction).

The effect of these factors is that:

- There can be a convergence of innate, internal and external factors that make borrowers in financial distress particularly susceptible to entering into these contracts notwithstanding that they are not in their financial interests.
- There will always be a percentage of borrowers who, because of innate factors, will always be susceptible to making poor decisions. Those small business borrowers with better financial literacy levels are more likely to make decisions based on an acceptance that they can no longer continue operating their business.

An indication of the extent to which innate factors operate can be inferred from other evidence of poor levels of understanding and judgement in relation to financial matters amongst a significant percentage of small business borrowers. These limitations are illustrated by findings that:

- 12 per cent of unincorporated sole traders stated that their primary reason for becoming insolvent was due to lack of business ability including underquoting or failure to assess potential of the business; and
- Small business clients of CPA members had relatively high levels of poor business practices in that:
  - it was not common for 37% of clients to prepare a cash flow forecast;

- it was rare or not common for 11% of clients to prepare financial statements; and
- it was rare or not common for 17% of clients to reconcile bank accounts.

This data suggests that there is a significant percentage of small business borrowers who may be unable to protect their interests because of innate factors (as illustrated by, for example, a lack of understanding of the importance of matters such as cashflows).

Other Problems

Small businesses also experience a range of problems in their dealings with lenders and brokers other than the practices discussed above. The complaints data from FOS and COSL shows that the main areas of complaint by small businesses are:

- Financial difficulty (noting that a total of 20 per cent of complaints to FOS and 22 per cent of complaints to COSL are in relation to financial difficulties). This includes complaints in relation to conduct such as a lender declining a current request for a hardship variation, failure to offer options when the borrower is in hardship, failure to respond to an application and failure to comply with industry codes of conduct.
- Advice related issues, including the failure to provide advice, or providing inappropriate or incorrect advice.
- Incorrect commissions, fees and charges being imposed for credit products and services. Disputes are more likely where:
  - Brokerage contracts do not clearly disclose, first, the maximum amount of fees that are payable, and, second, whether the fee is payable if the broker is unable to arrange credit.
  - Credit providers do not clearly disclose what fees the small business is liable to pay in order for their eligibility to be assessed, that is, where the fee is payable even when the lender decides not to provide credit.
- Minor levels of complaints were received in relation to matters such as breaches of privacy, fraud, misrepresentations, failure to follow instructions and unconscionable conduct.

These problems apply across the spectrum of lenders operating in the small business space, although, in terms of numbers, they are concentrated amongst banks, reflecting the level of market share they hold.

Government's Objectives

The objectives of government action are to:

- address the financial harm associated with the practices of fringe or rogue players; and

- to do so in a way that has a minimal impact, as far as possible, on the remainder of the industry.

Options

This RIS considers three options for addressing the issues raised by small business lending:

- Maintaining the status quo (including current non-regulatory options) – this would involve focussing on current industry codes of conduct and other current non-regulatory options.
- Prescriptive regulation, including extending responsible lending conduct obligations and detailed disclosure obligations to small business lending.
- Targeted regulation which may include registration or licensing with ASIC to ensure mandatory EDR scheme membership.

These options were previously outlined in the *2010 Green Paper National Credit Reform – Enhancing confidence and fairness in Australia's credit law*. Since the release of the paper, Treasury has refined the possible proposals for small business and outline three possible options for reform.

In these options 'small business' is defined consistently with the definitions in the ABA Code of Conduct and the ABACUS – Mutual Banking Code of Practice, and in substance means a business having:

- less than 100 full time (or equivalent) people if the business is or includes the manufacture of goods; or
- in any other case, less than 20 full time (or equivalent people).

This definition differs from that used in the beginning of the RIS, in relation to statistics in respect of small business (through the inclusion of a broader definition for manufacturing businesses). This definition is used as it is consistent with current definitions used in relation to credit in voluntary industry codes that apply to the majority of small business lending.

In these options 'persons engaging in small business credit activities' refers to small business providers of finance (irrespective of the type of contract through which finance is provided), and persons who conduct broking businesses in relation to such finance.

Option 1: maintaining the status quo

Maintaining the status quo would mean the retention of the continued hybrid regulation through:

- Broad general conduct prohibitions in the ASIC Act (for example, in relation to unconscionable conduct).
- Some transaction or sector-specific regulation through State legislation.

- Voluntary self-regulation where a lender or broker is a signatory to an industry code of conduct (noting that there is also capacity for signatories to self–exempt themselves, for example, Westpac Banking Corporation has limited the extent to which it complies with the Banking Code in relation to guarantees).

Impact on small business borrowers

This option would have no impact on small business borrowers. Whether or not they would be able to obtain a remedy would therefore continue to depend on whether or not:

- the lender or broker has contravened the ASIC Act, and they have the resources to commence legal action;
- they obtain finance through a hire-purchase arrangement or in relation to a farming business, in a State which regulates those activities; or
- the lender or broker is a member of an EDR scheme, and the complaint is within the terms of reference of the scheme.

A relatively small number of borrowers would continue to deal with fringe lenders and brokers. The outcomes for these borrowers would be:

- *Equity stripping:* Some small businesses may receive a benefit from the provision of credit where it allows them to continue trading, notwithstanding the cost of the transaction. Other businesses would experience losses with the dollar value of those losses largely based on the amount of equity in their home.
- *Fee farming:* Small businesses would incur a significant loss of equity without having received any benefit.
- *Asset stripping through non-repayment defaults:* Small businesses would experience a loss of equity, even where they are able to afford the repayments under their credit contract.

A larger number of borrowers would be unable to complain to an EDR scheme in relation to conduct by a person engaging in small business credit activities (with the complaints date from FOS and COSL particularly suggesting this would be an issue in relation to requests for hardship variations).

Government programs to improve financial literacy among the population generally would continue to have an impact, although this would be largely incremental in respect of outcomes.

Impact on persons engaging in small business credit activities

Maintaining the status quo would have no effect on industry.

Option 2: Prescriptive Regulation

Under this option the problems identified in this RIS would be addressed by prescriptive obligations, through extending the following obligations in the Credit Act to persons engaging in credit activities in respect of small business:

- the requirement to be licensed, and therefore meet the standards of conduct applying to holders of an Australian credit licence;
- responsible lending obligations, including the requirement to assess a prospective credit contract or lease as not unsuitable;
- detailed obligations in relation to disclosing the cost and terms if proposed credit contracts, or service contracts; and
- disclosure obligations to guarantors in relation to the contract under which they would be guaranteeing performance in the event of default by the borrower.

Impact on small business borrowers

Extending the application of the Credit Act to small business lending would have the following consequences, primarily from the need to conduct a suitability assessment:

- borrowers generally would be provided with significant benefits in relation to providing finance that is less risky;
- the time taken to process applications for credit would increase;
- the cost of credit would increase; and
- the availability of credit would be adversely affected, as lenders apply more conservative lending criteria (particularly where there may be some doubt as to whether the small business is viable or therefore would be able to meet the repayments under the credit contract).

The benefits of this proposal to small businesses include:

- lenders taking a more robust approach to whether or not the small business can meet the repayments (which may particularly affect businesses in 'start up' mode);
- disclosure obligations that could provide borrowers an improved capacity to assess the competitiveness of different credit products; and
- guarantors of small business loans would benefit from further regulation in this area, as the use of guarantees is much more extensive in small business lending than in the general provision of consumer credit.

Detailed and prescriptive requirements under this option would have the following impacts in relation to borrowers who continue to deal with fringe lenders and brokers:

- *Equity stripping:* They would have a specific statutory remedy where they could not afford to repay the loan (so that they would be less likely to obtain credit in the first place).

  – Some small businesses may therefore find their financial difficulties exacerbated through being unable to access alternative credit. They would also be unlikely to obtain alternative finance, even where they would meet current eligibility criteria, because of the need for lenders to introduce more robust assessment procedures.

- *Fee farming and asset stripping through non-repayment defaults:* The Credit Act currently does not provide specific remedies for this conduct. However, small businesses would be able to seek compensation or other remedies through complaint to an EDR scheme (as membership would now be mandatory).

Impact on persons engaging in small business credit activities

Extending obligations under the Code to small business lending will impose a significant compliance burden on the relatively small number of industry participants who do not hold an ACL. Lenders and brokers who do not already hold an ACL would incur costs as follows:

- Costs in relation to obtaining and holding an ACL:

  – Assuming the annual cost is based on the volume of small business loans provide or arranged (and charged at the same rate as for an ACL), this amount would range from $450 to $21,000.

  – There would be additional costs associated with external training and competency arrangements and internal compliance.

  – EDR membership would result in the following fees: an application fee of about $165 - 220; an annual membership fee (calculated according to membership type and the size and nature of business); and complaint-handling fees.[8]

- Entities would incur costs in relation to meeting the responsible lending conduct obligations, and the other obligations referred to above. If they sought legal advice for this purpose they could expect to incur transitional costs of at least $40,000, but possibly more.

Persons engaging in small business credit activities who already hold an ACL would incur fewer transition costs, as they would simply apply existing compliance practices to a broader category of contracts. However, they would incur higher transaction costs in relation to their dealings with small businesses.

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[8] http://www.cosl.com.au/Member-Fees; http://www.fos.org.au/centric/home_page/members/apply_for_membership.jsp

These associated costs may potentially be passed on to consumers in the form of increased costs of credit or fees or charges. It may also lead to a reduced pool of lending and brokering services as some entities may elect to withdraw from the small business lending market.

A decision to proceed with this option would be based on the following factors:

- An assumption that there are similarities in the issues faced by individual borrowers, and small business borrowers, so that it would be logical to extend similar protections to small businesses under the Credit Act. It is arguable that the two categories of borrowers overlap in that some small business borrowers share the same risks and problems, including lack of finance and lack of financial sophistication.
- A view that delivery of prescriptive requirements, and the subsequent benefits to small business borrowers outweighed the disadvantages identified above in relation to access to credit, and the cost of that credit. Given that the scale of the predatory lending activities identified in this RIS is relatively low, and confined to those small business borrowers who are in financial distress, this approach would result in a significant burden on all borrowers and all lending when the problem is more contained in scope.

Option 3: Targeted regulation

Under this option the problems identified in this RIS would be addressed by the following measures:

- Introduce a 'negative licensing' requirement for lenders and brokers who engage in credit activities in relation to small business borrowers (where they are not already holders of an ACL).
  - Negative licensing would operate in a similar manner to the registration model adopted during the transitional period of the National Credit Reforms in the *National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009* (Transitional Act). Under this model registration would be automatic, unless the person met specific excluding criteria (for example, they were bankrupt or had been banned from holding an ACL).
  - The registration model worked very efficiently during the transitional period, with the first person able to register within 10 minutes of ASIC opening its processes for applications.
  - Entities or individuals who engaged in systemic misconduct or extreme incompetence could be banned by ASIC (under arrangements similar to those applying to those who currently engage in credit activities).
- It would be a condition of licensing that a lender or broker was a member of an EDR scheme.
  - Imposing a mandatory EDR requirement in this way would provide small businesses with universal access to a no-cost forum for resolving disputes.

- Introduce disclosure requirements for:
  - lenders and brokers to give notice of the costs and repayments before the small business enters into a contract (that is, to provide disclosure of the likely fees and charges, including any fees that are non-refundable, the interest rate, and the repayments under the proposed contract); and
  - brokers to give notice of the cost of their services (or a reasonable estimate), and whether or not the fees are payable irrespective of whether or not the broker is able to arrange credit.
- Introduce a remedy for asset-stripping conduct in relation to distressed borrowers that would cover situations such as where:
  - where the credit will not be used to increase the output of the business but is intended by the borrower to allow for a measured or unpressured exit strategy for the business that maximises the return to the borrower of their existing assets, and where the credit does not provide this benefit to the borrower, and in fact depletes their assets;
  - where a lender refinances an existing loan, and the small business is in default or facing default under that existing loan, and the terms of the new loan (especially with respect to meeting repayment obligations at the end of the contract) are inconsistent with the borrower's purpose; or
  - where the lender relies default clauses in situations where their purpose is to make it unlikely the business can repay the debt without selling their assets that are security for the loan.

In order to minimise the impact on mainstream operators it would be necessary for the statutory remedy to operate in a way that made clear what conduct lenders or brokers could engage in without infringing the prohibition. This would be done based on a comparison of the conduct of responsible lenders against predatory lenders such as that set out in Table 1 to identify the key elements of the behaviour it is intended to prohibit. This would include, for example, a failure by lenders and brokers to identify an appropriate exit strategy at the end of the proposed contract. The remedy would be developed through detailed consultation with stakeholders, including comments on exposure drafts of the proposed provisions.

The combination of providing borrowers with universal access to EDR schemes (as a forum to resolve complaints outside court action) and mandating clear disclosure of fees and charges is considered sufficient to address the problems identified in relation to 'fee farming' activities, without introducing a specific statutory remedy.

Impact on small business borrowers

Small business borrowers would benefit from greater accountability of fringe operators for misconduct (and therefore a reduced risk of this misconduct) as a result of:

- universal access to EDR schemes (which would particularly assist small businesses in their dealings with fringe operators as almost invariably they are not members of an EDR scheme);
- introduction of a specific remedy for asset-stripping conduct (given that the current remedies are inadequate to comprehensively provide compensation to the borrower); and
- ASIC being able to exclude from the industry entities and individuals who cause systemic financial loss.

The analysis in relation to distressed borrowers identified three types of factors that contribute to poor decision-making, innate, internal and external. This reform would primarily address external factors by seeking to prevent the type of conduct by brokers and lenders that influences these decisions; that is, it focuses on the conduct of the lenders and brokers and does not in itself depend for its operation on the reasons borrowers enter into these contracts. The proposed remedy is therefore predicated on deterring the conduct (in combination with the other reforms as discussed below).

It would therefore not affect innate and internal factors (such as poor financial literacy and stressed decision-making). However, the objective of the reform is not to protect small business borrowers from the consequences of poor decision-making in all circumstances, but only where the fringe lender or broker seeks to take unfair advantage of that weakness. This would be reflected in the limitations in relation to the formulation of the remedy; it is not proposed that it would provide a remedy in all cases where the borrower could not afford the repayments but only where additional factors are present.

Each practice identified in the problem identification section operates in a different way (see Table 1). This results in different consequences as to extent to which the reforms will be able to reduce the damage from the conduct, as follows:

- *Equity stripping:* Small businesses suffer losses because there is no discussion of the exit strategy at the end of the loan or the small business has a different expectation from the lender of their position at the end of the loan term.

  The proposed formulation of the remedy will protect lenders where they discuss and identify an exit strategy with the borrower before they enter into a contract and ensure it is realistic and consistent with their own understanding (as is currently the case in the procedures adopted by mainstream lenders).

  The outcome would therefore either be that:

  – the discussion takes place and the lender and borrower can agree on appropriate terms; or

  – the borrower has unrealistic expectations and is prepared to enter into a contract on any terms, in which case the lender would be at risk, should they proceed with the loan, where the terms meant they were taking advantage of the borrower.

- *Fee farming:* Small businesses suffer losses in the absence of clear disclosure and where the letter of offer is made on the basis of the level of equity held by the borrower, rather than the likelihood they will ultimately be provided with a loan.

  It is proposed to allow this issue to be addressed by EDR schemes as, first, the level of fees charged will mean the matter is not excluded under the monetary limits in their terms of reference (as would not necessarily be the case with the other two practices), and, secondly, they can make decisions on broader criteria than those available to a court, including taking into account the level of costs charged by mainstream providers.

  The extent to which this practice was addressed would therefore depend on the approach taken by the EDR schemes. This would need to be monitored and considered in the future review of the reform.

- *Asset stripping through non-repayment defaults:* This is a practice that is largely 'invisible' to the borrower in that it would not be a reasonably foreseeable outcome when they enter into the contract. The change in lender behaviour is therefore likely to depend, to a larger extent than the other practices, on the extent to which ASIC enforces the remedy.

However, some fringe lenders and brokers may continue to operate without changing their practices, and that results in similar outcomes for borrowers. It could also be expected that there would still be some small businesses that would continue to rely on these persons (for the reasons discussed above, including a poor level of financial decision-making).

Nevertheless, it would be expected that the scale of these activities would decrease as a result of:

- brokers and lenders having a greater risk that their conduct will give the borrower a right to seek compensation;

- the enhanced capacity of small businesses to resolve complaints through EDR schemes, rather than court action (given that the fringe activity is partly based on the low likelihood the borrower will be able to seek compensation even where they have a right to it);

- clearer disclosure could result in some borrowers electing not to proceed with transactions (noting that this is only one factor affecting their decisions and is likely to be an outcome among more sophisticated borrowers); and

- potential enforcement action by ASIC will have a greater deterrent impact in that it will be easier for ASIC to take enforcement action that is effective and more certain in outcome, while lenders and brokers would also face the risk of being excluded from the market through a banning action (which is not currently the case).

A small number of small businesses may continue to deal with fringe lenders and brokers. The outcomes for these businesses would be:

- *Equity stripping:* Some small businesses may receive a benefit from the provision of credit where it allows them to continue trading, notwithstanding the cost of the transaction. Other businesses would experience losses based on the level of equity in their home.
  - As with Option 2 some small businesses may therefore find their financial difficulties exacerbated through being unable to access alternative credit from fringe lenders. However, they would be in the same position as they are currently, that is, they would be able to access alternative finance where they would now meet current eligibility criteria, as lenders would not be required to introduce more robust assessment procedures generally.
- *Fee farming:* Small businesses would incur a significant loss of equity without having received any benefit.
- *Asset stripping through non-repayment defaults:* Small businesses would experience a loss of equity, even where they are able to afford the repayments under their credit contract.

Some small businesses who ultimately benefit from equity stripping loans may therefore find their financial difficulties exacerbated through being unable to access alternative credit, where the provision of credit allowed them to continue trading and therefore provided a long-term benefit. The analysis in the Problem Identification section suggests that this would be an inadvertent consequence, rather than the usual consequence of dealing with fringe lenders and brokers.

The lack of access to this source of funds would not be expected to have any impact on the cost of funds charged by other lenders as these are substantially determined by other factors (particularly, in the case of private lenders, the rate of return paid to investors).

Universal access to EDR schemes would also provide more general benefits to small businesses in relation to complaints other than in relation to asset stripping or fee farming activities. The complaints data from FOS and COSL indicates that this requirement would be most helpful in providing small businesses with variations to their repayments on the grounds of hardship (where this is appropriate).

Impact on persons engaging in small business credit activities

In summary, this proposal would:

- have a minimal impact on the majority of lenders and brokers who currently already comply with the proposed requirements (as the remedy for distressed borrowers would be targeted at exploitative behaviour that is not reflected in the practices of mainstream lenders);
  - They would not incur any new costs in relation to being licensed or a member of an EDR scheme (as they meet existing requirements).

- One-off costs may be incurred in reviewing their disclosure requirements and lending practices in relation to the proposed remedy for predatory lending.

impose new compliance and cost burdens on a relatively small number of persons engaging in small business credit activities who would have to meet new requirements in relation to registration, EDR membership and giving notices (but with these costs lower than those they would incur under Option 2); and

- deter or prevent systemic and ongoing misconduct in relation to predatory lending and mitigate the financial impact on borrowers of such conduct by providing a more effective remedy than is currently the case.

More specifically, businesses are estimated to incur the following costs:

- Notification requirement to ASIC - minimal costs (noting that under a similar model in relation to a transitional period for Australian credit licences the first person was able to register 10 minutes after registration was open).
- EDR membership costs (for those who are not already members) as follows: an application fee of between $165 - 220; an annual membership fee (calculated according to membership type and the size and nature of business); and complaint-handling fees where a dispute is brought before the EDR scheme.
- EDR membership: indirect costs arising from complaints - some credit providers with relatively small lending portfolios, primarily private lenders, may tighten their lending criteria (for example, require greater security as a condition of providing credit) or increase their costs. These changes could be made where they are concerned that they need to cover potential losses associated with delays in receiving payments while a hardship variation is being considered by the EDR scheme. The exit of these lenders from the market would reduce the availability of credit, but only in a minor way (given the small scale of their lending).
- Changes to disclosure requirements – review of existing documentation and implementation of any changes. This would vary according to the number of different types of contracts that need to be reviewed, but would be expected to be a maximum of $50,000 and considerably less for those offering only one or two products or for brokers. There would be no costs for the majority of brokers who do not charge fees, but are remunerated by way of commissions.
- Avoidance of predatory lending – minimal costs for those who do not engage in this conduct, but who may need to review their practices and documentation.

It is not possible to quantify the costs exactly for each lender or broker. However, the impact in respect of costs for different classes of market players can be summarised as follows:

- Mainstream lenders who already hold an ACL:

- They would not incur any new costs in relation to being licensed or a member of an EDR scheme (as they meet existing requirements).

- One-off costs may be incurred in reviewing their disclosure requirements and lending practices in relation to the proposed remedy for predatory lending. These costs cannot be estimated as they would vary from lender to lender according to the nature of their business, but would be low (in that mainstream lenders would be expected to largely meet these standards).

- Mainstream brokers who already hold an ACL:

  - They would be in the same position as lenders, except that they would not incur costs in relation to reviewing their disclosure requirements where they are remunerated by commissions. The extent of this practice is unknown but very common in relation to small business broking.

- Mainstream lenders who do not hold an ACL (such as niche small business lenders):

  - They would incur a cost in terms of time in complying with the notification requirement.

  - They would incur costs in joining an EDR scheme (noting that some are already members on a voluntary basis or as a condition of being a member of an industry body).

  - They would incur one-off costs in reviewing their disclosure requirements and lending practices as discussed above.

- Mainstream brokers who do not hold an ACL:

  - They would incur a cost in terms of time in complying with the notification requirement.

  - They would incur costs in joining an EDR scheme (noting that some are already members on a voluntary basis or as a condition of being a member of an industry body).

  - They would incur one-off costs in reviewing their broking practices and may incur one-off costs in reviewing their disclosure requirements, as discussed above.

- Fringe lenders and brokers:

  - They would incur a cost in terms of time in complying with the notification requirement.

  - They would incur costs in joining an EDR scheme.

  - They would incur one-off costs in reviewing their disclosure requirements.

– They would incur significant costs in reviewing their broking and lending practices, where they decide to change them in response to the proposed reform. There would be a consequential impact in relation to the extent of their business activities, as they would need to adopt more rigorous eligibility criteria (similar to those adopted by mainstream providers).

Consultation

Extensive consultations and reviews have been conducted in relation to these reforms. Submissions to the Phase Two Credit Green Paper were received which provided stakeholder feedback on Code pre-contractual disclosure.

Treasury has also convened two consultation groups as follows:

- Industry and Consumer Representatives Consultation Group (ICRCG). Its membership comprised of representatives of the banking, financial services, mortgage and finance brokers industries, consumer credit legal services, consumer advocates, ASIC, and the Department of the Treasury. All major industry bodies are on this group, and are able to disseminate information to their members and provide their feedback. Consultation with this group has generally occurred on a monthly basis. The membership of the group was expanded to cover a number of organisations whose membership specialises in small business lending, including the Short Term Lenders Association (representing lenders who provide lump sums for periods such as three months), the Commercial and Asset Finance Brokers Association, Short Term and Bridging Finance Association and industry bodies for accountants.

- The Financial Services and Credit Reform Implementation Taskforce (FSCRIT), comprises representatives from State and Territory departments and agencies, ASIC and the Department of the Treasury. Its main role in relation to Phase Two is to ensure proposals are developed in accordance with the COAG timetable. FSCRIT consultations have been conducted on a regular basis, according to need.

Stakeholder views

Submissions to the Phase Two Credit Green Paper on small business were as follows:

- There was no support for Option 2 – that is, applying the Credit Act without modification to small business lending.

- Industry was concerned about the impact reforms could have on both the cost and availability of credit for small businesses.

Recommended Option

Option 3 is the preferred option. Under Option 3, small business lending will be regulated by:

- Introducing a negative licensing requirement for lenders and brokers who engage in credit activities in relation to small business borrowers.

- Mandating membership with an external dispute resolution scheme.
- Where it is appropriate, banning persons from the market where they have engaged in systemic misconduct.
- Introducing notice requirements for lenders and brokers to give notice of key features of their services or products before the small business enters into a contract (that is, to provide disclosure of the likely fees and charges, and interest rate, and the repayments under the proposed contract).
- Introducing remedies for asset-stripping practices.

This approach provides for a targeted response and recognises that any intervention in the relationship between a small business borrower and a broker or lender should be limited, and should not seek to protect them from the consequences of poor decisions per se. Option 3 therefore proposes to address conduct where intervention is warranted, as the purpose of the broker or lender is to construct a transaction in a way that has particular risks for borrowers, and where the conduct is inconsistent with the approach of other providers.

- The reform will therefore only have a narrow and incremental benefit for small businesses in that, first, the reforms only address the position of a relatively small number of borrowers, and, second, the deterrent effect of the reforms is unknown.
- The limited range of the reforms means that it is considered unlikely to have a significant impact on the majority of lenders and brokers, where they already either hold an ACL or are a member of an EDR scheme. However, all small business lenders will face one off implementation costs to change disclosure procedures and modify other practices to address regulatory risk. Most lenders would not need to make substantial changes as they are already complying with, or are in a position to readily comply with the reforms; they have been framed in a way that is intended to result in higher costs for those who currently engage in the asset-stripping practices. This means that some fringe lenders would incur more substantial costs related to the new requirements in relation to registration, EDR membership and giving notices However, it is not possible to be certain as to the extent of those costs.

This option is preferred to Option 2, as it will provide targeted protections to small business borrowers, where the financial consequences for individuals are currently severe. It also seeks to deter the conduct by allowing for ASIC to exclude entities and individuals from the small business credit market, and keeps compliance costs and burdens lower than under that Option. It takes a balanced approach that is consistent with the level of problems identified in this RIS, and ensures continued timely and efficient access to finance.

It is preferred to Option 1, as while it will have an impact on all small businesses, and lenders and brokers, it is considered the impact on the majority of lenders and brokers will be low (acknowledging that it is, however, not possible to accurately quantify the costs they would incur).

Implementation

This reform will be implemented through legislation to be passed during 2012, as part of the changes in Part Two of Phase Two of the Credit Reforms. This reform will be effected through amendments to the Credit Act which will mean that ASIC will be responsible for administering and monitoring compliance.

Review

The terms of the National Credit Law Agreement agreed by the Commonwealth and all States and Territories in 2009, requires the Commonwealth to commence a review of the operation of the National Credit Law, no later than two years from commencement.