Australian Banking Association

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To whom it may concern

Treasury RIS consultation on Enhancements to Unfair Contract Term Provisions

The Australian Banking Association (**ABA**) supports an effective regulatory regime that provides consumers and small business with a strong level of protection from unfair contract terms (**UCTs**) in standard form contracts.

As part of the new Banking Code of Practice (**BCoP**), Australia's banks have significantly increased protections for small business, giving new rights both to small business owners and customers. Part of these changes were as a direct result of the ASIC review of unfair contract terms.

We note that this consultation is focused on options to strengthen UCT protections available for small businesses under the *Australian Consumer Law* and the *Australian Securities and Investments Commission Act 2001* (**UCT legislation**).

In line with our views expressed in the review of the current framework of UCT protections for small business under the UCT legislation completed in early 2019, the ABA believes it is still too early to be contemplating further changes. Given the small business UCT protections only came into force in late 2016, our view is that the regime's relatively short operating period is not sufficient to fully review its effectiveness and impact. We note that the consultation paper contains very limited quantitative findings on the need for further protections.

The ABA's key comments on the options in the paper are focused on the issue of legality and penalties in part four. We support maintaining the current enforcement regime or if further reforms are contemplated, we believe that strengthened compliance and enforcement activity would most effectively deliver the intended objective of providing stronger UCT protections for small business.

In our view, making UCTs illegal and attaching penalties will result in a more legalistic approach to contracting and an adversarial process with regulators. We believe that a supervisory focused enforcement approach by regulators can best deliver improved outcomes for small business. We point to how ASIC conducted its review of UCTs in banking standard form contracts and the resulting changes applied across industry as a case study in how the existing UCT legislation can operate effectively. We elaborate on this issue and provide comment on other relevant options below.

The ABA and its members are encouraged by the Government's statements that a meaningful deregulatory agenda will be a key element in their plan for economic recovery post COVID-19. We note the Treasurer's call for businesses large and small to look for reforms that promote a flexible and nimble regulatory framework. The ABA observes that removing obstacles to lending rather than tightening them is where the current priority should be.

If you have any questions or require further information, please contact me on (02) 8298 0417 or at justin.mining@ausbanking.org.au.

Yours sincerely

Justin Mining
Policy Director

Australian Banking Association

1. Legality and penalties

The ABA supports 'option 1 – status quo' or 'option 2 – strengthened compliance and enforcement activities' on the following grounds:

- strong enforcement mechanisms already in place under the existing UCT legislation, including the ability of the ACCC or ASIC to seek a declaration that a term is unfair
- any further reform contemplated should focus on strengthened compliance and enforcement activities as this is the most effective approach in delivering stronger protections for small businesses
- making UCTs illegal and attaching penalties will result in parties adopting a more legalistic approach and raises inherent difficulties due to the subjective nature of the law.

1.1 Strong UCT enforcement mechanisms already in place

The ABA submits that the current UCT enforcement regime is appropriate and carries significant consequences for a business that is found to have imposed an unfair term in a small business standard form contract. This is the basis for our support for option one and retaining the current provisions.

The UCT legislation enables a court or relevant tribunal to declare terms in standard form small business contracts as unfair. A party to a relevant contract, the ACCC or ASIC has standing to seek a declaration that a term is unfair.

Under the current provisions, if a court finds that a term is unfair, it can make a range of orders, including:

- declaring all or part of a contract to be void
- varying a contract
- refusing to enforce some or all of the terms of a contract or arrangement
- directing a party to refund money or return property to the small business affected
- directing a party to provide services to the small business affected at the party's expense.

This can have serious legal and financial consequences given that if a court finds that a term in a standard form contract is unfair, the court can order it is made void and is effectively treated as if it never existed. Importantly, the business must also remove the term from future contracts, or it will be treated as a contravention of the UCT legislation.

In addition, there are other significant implications for businesses, such as reputational damage and the time and expense of dealing with legal proceedings.

1.2 Compliance and enforcement activity

In the event that Treasury does not support option one, the ABA believes that an approach based on strengthened compliance and enforcement activities would be the most effective means of delivering greater protection for small business from UCTs in standard form contracts.

Since the UCT regime came into force for small business, the ACCC and ASIC have both made enforcement of the legislation a key priority and undertaken significant compliance activities. Both regulators have been active in UCT matters including undertaking litigation, employing administrative mechanisms, entering into court enforceable undertakings and overseeing direct supervisory oversight of with industry.

In many cases, the regulators have engaged directly with businesses on potential UCTs and this has often resulted in changes being made to standard terms, which often end up having broad applicability across an industry. The ABA believes that this is a particularly effective approach in delivering improved protections for small businesses, which is the objective of the UCT legislation.

Case study: ASIC compliance review of small business contracts in banking sector

The ABA highlights ASIC's review of the small business lending contracts provided by ANZ Bank, the Commonwealth Bank of Australia, National Australia Bank and Westpac as a case study into how effective this supervisory approach can be in delivering improved protections.

This process involved ASIC reviewing the contractual terms of the standard form small business contracts offered by each bank and then working with them to make changes to ensure compliance with their UCT obligations. As a result of the review, these four banks made significant changes to their standard form contracts, including removing clauses from its loan contracts deemed as unfavourable to a small business customer.[1]

This included the removal of:

- material adverse change events of default - clauses which gave banks the power to call in a default for an unspecified negative change in the circumstances of the small business customer. These clauses have been removed so that loans cannot be terminated for an unspecified negative change in the circumstances of the customer
- financial indicator covenants (e.g. loan to value ratios) – removing these covenants as triggers for default for most small business loans (with a few exceptions for specialised loans such as property development, margin lending and foreign currency loans), and
- unilateral variation clauses - banks have restricted their ability to vary contracts for specific circumstances, and where such a variation would cause a customer to want to exit the contract, the banks will provide a minimum of 30 days for the customer to do so.

This process led to specific changes that now apply to all ABA member banks through the Banking Code of Practice **(BCoP)**. This was an effective regulatory approach in getting parties to amend standard form contractual terms that may be unfair to small business without the need for time-consuming and expensive court proceedings and delivering better outcomes for small businesses more quickly.

We also note that the ability of regulators to act upon UCTs was also enhanced in 2018 with ASIC and the ACCC being granted increased investigative powers to compulsorily obtain information, documents and evidence from parties to a contract to determine whether to make an application to the court for a declaration that a term in an eligible contract is unfair. The ABA believes that this gives the regulators a comprehensive set of powers to supervise industry and enforce compliance with the UCT legislation.

1.3 Making UCTs illegal and attaching penalties

The ABA strongly opposes 'option 3 – making UCTs illegal and attaching penalties'.

The law around UCTs is very subjective and is not a matter where it is possible to state a precise or universal 'bright line' test. There are many circumstances where it is unclear whether a term of a contract may be unfair and reasonable minds will differ on whether what is unfair in one contract or particular industry is unfair in another. Given this uncertainty, the ABA does not believe it is appropriate to attach illegality or civil penalties to findings of UCTs.

Further, we believe that amending the UCT regime to enable findings of illegality and imposition of penalties may result in a more legalistic approach by parties to relevant contracts. This could lead to more court disputes over individual contracts, which can be time-consuming and expensive for all parties, particularly as any court case relating to one term in one contract may not have universal application and will likely lead to increased costs for consumers and small businesses. This would undermine the effectiveness of the current supervisory approach often undertaken by ASIC and ACCC that can lead to widespread changes in contractual terms. We noted the way that this has operated effectively in the banking sector in part 1.2 above.

[1] See *Report 565: Unfair Contract Terms and Small Business Loans*, ASIC, March 2018.

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2. Flexible remedies

The ABA supports 'option 1 – status quo' or 'option 2 – UCTs not automatically void'.

We believe that there may be some merit in a court having the power to determining appropriate remedies when a court declares a small business contract term to be 'unfair'. This could include the court having the power to vary the UCT to give effect to the intention of the contracting parties.

In relation to 'option 4 – UCTs used in similar circumstances', the ABA believes that this would be difficult to apply in practice because it requires a subjective assessment on whether a clause is the same or substantially similar and would ultimately depend on the operation of the clause in the contract as a whole.

3. Small business – definition of a contract

The ABA supports the UCT small business contract test being aligned with the below BCoP thresholds. This would provide certainty for banks and our customers about what contracts would be covered under the regime.

We believe the following thresholds in line with those in the BCoP would be preferable for application of the standards for small business:

- newer than 100 full-time equivalent employees, and
- it has less than $3 million total debt to all credit providers.

If this is not accepted, the ABA supports 'option two – replace headcount threshold with turnover threshold' as turnover is considered a more accurate measure of the size of a business.

The ABA proposes that this must reflect the turnover of a business group, not just a borrowing entity, along the same lines of existing practice with the BCoP. For example, if the start-up subsidiary of a multinational corporation (or other similar SPV structures), with just $1 million turnover and 10 employees in its Australian entity, sought a $3 million loan, this would be subject to UCT restrictions. This may inhibit the terms upon which a lender may seek to offer a loan (e.g., restrictions on covenants and undertakings, or reduced amount of credit the lender would be willing to offer) and this may in turn affect the ability for lenders to compete for that loan. These types of entities, which may have billions in turnover, are not the types of businesses to which UCT protections should apply.

The headcount limb is not relevant for most transactions in the banking sector as this information is typically not collected or the exact figure can be very uncertain due to the use of contractors and casual employees.

4. Value threshold

The ABA supports 'option one – status quo' - these value thresholds were subject to significant scrutiny and debate during the development of the UCT legislation and have been widely considered in a number of other subsequent reviews. There does not appear to be any significant new data or evidence to support any changes.

At the same time, there is no data or modelling to show what the proposals to increase the contract value threshold or remove it altogether would mean in terms of bringing more contracts within the UCT law regime. This could be very significant as these larger contracts falling within the UCT regime would generally require much more scrutiny before signing and be more heavily negotiated by the parties.

This approach has the potential to have a significant impact on small business lending in the banking sector. This has been evidenced in the Royal Commission's analysis of these issues and ASIC's ongoing role in monitoring the impact of the changes.

We provide comment on each of the following options below.

'Option 1 – status quo'

The ABA supports maintaining the current value threshold and we note the lack of substantial evidence in the impact analysis. Treasury does not seem to consider that it would be possible for a contract-issuing party to avoid the UCT protections by raising the contract price or combining multiple items into a single contract whatever the threshold is set at. The focus needs to be on setting the most appropriate threshold based on all the factors

'Option 2 - increasing the value threshold to $5 million'

The value threshold of small business lending has been subject to significant review and scrutiny in recent years, through the development of the BCoP and the Royal Commission.

A key issue in the development and approval of the revised BCoP was the setting of a $3 million total debt threshold to be defined as a small business and be eligible for the protections. ASIC's approval of the BCoP came upon its view that the definition applied the protections to the vast majority of small business customers who would significantly benefit. As a condition of its approval of the BCoP, ASIC required banks to commence an independent review of the definition of small business within 18 months of commencement to assess the suitability of the $3 million total debt threshold in the definition. In preparation for that review, ASIC is requiring ABA banks to provide to ASIC periodical data in relation to small business disputes.

This was also subject to significant analysis through the Royal Commission, which recommended a move to a $5 million threshold. The ABA held significant concerns around this recommendation given a blanket move to a $5 million threshold (noting that this would be per contract not total debt) would have a likely significant impact on banks and their lending to small business. This could have a significant impact on material access to credit for small business borrowers and reduce competition (e.g., greater impact on smaller lenders who may not be able to compete as effectively for loans in the $3-5 million range if they are prevented from exercising key risk triggers). The Council of Financial Regulators (**COFR**) considered our concerns and in March 2019 it announced that its members "supported maintaining the current borrowing threshold to define small businesses within the Code, with an independent review to be undertaken within 18 months of the Code's commencement".[2] Further, COFR members expressed a view that "a limit based on total credit exposures is more appropriate than one based on loan size".

The ABA does not believe it would be appropriate to increase the value threshold for UCT purposes until the review of the operation of the BCoP's definition is completed and concerns over availability of credit are considered.

'Option 3 – remove the value threshold'

The ABA strongly opposes this option and we particularly note the impact that this would have where banks offer products to both wholesale and retail clients and who do not obtain information about a customer's number of employees. Loan products offered to wholesale clients are not reviewed for UCTs. Without the certainty afforded by the value threshold, this certainty is removed when dealing with wholesale lending products. It is also the only test that is the most definitive and does not fluctuate in comparison to the number of employees or a turnover test.

5. Clarity on standard form contracts

The ABA notes that this is not a significant issue for the banking industry given that most banking contracts are considered standard form unless they are specifically drafted on a bespoke basis using legal review.

We note in relation to 'option 2 – repeat usage', Treasury needs to consider providing clarity on what would constitute 'repeat usage' where a bespoke contract is drafted (e.g., in circumstances where a single clause or term of a contract is different in a contract would this mean it falls into the bespoke category or would it still be considered 'repeat usage').

[2] Council of Financial Regulators, *Quarterly Statement by the Council of Financial Regulators – March 2019*, 20 March 2019.