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Lead Ombudsman – Banking and Finance
Australian Financial Complaints Authority
GPO Box 3
Melbourne VIC 3001
Via email: consultation@afca.org.au

Re: AFCA approach to Appropriate Lending

We thank you for the opportunity to provide a written submission to this very important consultation piece.

We hold significant concerns with AFCA's proposed approach to determine complaints regarding commercial lending. We are concerned with both the creation of the framework itself and the lack of detail around how it will be applied. We do not support this innovation by AFCA.

The proposed approach threatens to create a significant divide between commercial lenders who are members of AFCA and who are not. The approach creates an imbalance in the rights of customers. The approach will strengthen the two-speed regulatory regime that has been created where the rights of parties to a commercial loan are dependent on EDR membership rather than the service provided. The approach involves novel interpretation of existing laws that have not been subjected to judicial consideration.

In this paper, our reference to "commercial lending" includes all forms of finance not regulated under the National Consumer Credit Protection legislation.

The proposed framework threatens to create significant instability in the commercial lending sector. It will support an increase in strategic EDR claims and abuse of the EDR framework. It has potential to cause longer term ramifications for industry as the inconsistency of outcomes achieved by commercial borrowers depending on whether they obtained finance from a financial firm that was an AFCA member or not will increase calls for all lenders to be subjected to the jurisdiction of AFCA. It has always been our view that AFCA's jurisdiction should be defined by whether the borrower is a consumer and the credit is consumer credit rather than by whether the provider is a member.

There is extraordinary diversity in the commercial lending space. The thinking outlined in the draft approach does not differentiate between the practices that might be manageable for large, well-capitalised institutions and all of the other entities that operate in the commercial lending space.

Small businesses make a significant contribution to the Australian economy, accounting for nearly one-half of private sector industry employment and contributing approximately one third of private sector industry value added[1]. Access to finance is a critical part of the success of entrepreneurs and aspirational small business owners.

[1] Australian Bureau of Statistics (2011) Cat No. 8155.0.

The proposed approach to appropriate lending presents as an amorphous concept that provides very little certainty to business or fairness to parties to a dispute.

AFCA's framework of reference is anchored to consumer disputes. This has coloured its approach of commercial disputes as AFCA staff attempt to reframe commercial lending practices into a consumer framework they are familiar with.

Commercial lenders take a very different approach to assessing a commercial loan application when compared to consumer loans. Many of the considerations for consumer loans are prescribed by NCCP legislation. There is no equivalent framework for commercial loans. This is not due to any deficiency in the laws that apply to commercial lending.

Commercial lending decisions are often more nuanced than consumer loans and involve the regular exercise of lender discretion. Lenders are able to make decisions based on any factors they consider material. Their lending decisions place different weight on source of income, risk of default and performance. There is no benchmark or threshold that can be applied to impose consistency across the Australia-wide commercial lending industry. We are concerned that AFCA's draft approach is an attempt to create a set of rules to make it easier to adjudicate commercial disputes – however those rules will only be applied in retrospect against a financial firm that was not subject to those rules at the time the lending decision was made. The fact that these rules can only be asserted against lenders that are AFCA members creates a schism in the treatment of commercial lenders and commercial borrowers based on factors that are unrelated to the activity.

AFCA decision makers are not judges, yet they hold more power than the courts. With a regime where the rights of the parties are incredibly imbalanced, it is no place for ambiguity or inconsistency. We are concerned that AFCA cannot remain impartial in hearing commercial matters nor do its staff have the necessary expertise to adjudicate commercial matters.

The rules of AFCA proceedings erode the rights of the defending party. AFCA rules permit AFCA staff to ignore the rules of evidence, take into account fabrication, hearsay and unsubstantiated claims, not hold complainants to account for mistruths and deny defendants any rights of appeal. AFCA staff are not required to apply law. They can apply novel interpretations of law, industry Code and industry guidance, ignore legal precedent or make binding decisions against parties involving claims of hundreds of thousands of dollars based on 'what is fair in all the circumstances'. Fairness is judged through the eyes of the complainant.

What is fair in all the circumstances is that a complainant should have no recourse against a lender that has acted reasonably and complied with its explicit legal obligations. What is fair in all the circumstances is that financial firms should not be charged thousands of dollars in AFCA fees where they have done no wrong. We feel that neither of those outcomes are certain when subjected to the AFCA process.

A matter which we have always regarded as improper is that AFCA presides over commercial disputes solely based on whether the entity being complained against is a member. Jurisdiction is not decided by legal boundaries but by happenstance. Two entities engaging in the same conduct are subject to a completely different set of obligations based on whether they happen to also provide

consumer services under an Australian Credit licence which compels them to hold AFCA membership. It is like having different road rules depending on what model car you own and not being told what those rules are before you drive. This could be remedied by AFCA recognising that its jurisdiction is defined by whether a loan is for a consumer purpose and where the borrower is a consumer. We support removing commercial disputes from AFCA's jurisdiction.

It is the legislative intent of Parliament that commercial lending not be regulated under consumer credit laws. This position is evident from the legislation, and has also been the subject of specific reassurances over years from political parties. It was further reinforced by Commissioner Hayne from the Royal Commission into Misconduct in the Banking and Superannuation Sector. Despite all of this, AFCA is pressing further into unregulated lending and attempting to create a set of rules that parallel the consumer regime.

What AFCA is proposing by creating a framework of 'appropriate lending' is to bypass the intent of parliament and to impose consumer-style regulation on commercial lending. With even less certainty than the consumer regime, the commercial regime is intended to be based on standards of behaviour which have been created by the Ombudsman where there is no common national position established by legislation that would give a commercial lender any understanding of what is required.

With the reverse onus-style approach that AFCA takes to dealing with complaints, we would be extremely concerned that AFCA would form an adverse view about an entity where it is unable to produce records that, by law, it is neither required to produce nor retain ……and to be clear, what AFCA has identified in the consultation paper as "agreed or generally understood standards of conduct" is no more than AFCA's interpretation of law and industry practice. There is very little judicial consideration of the application of some provisions of the ASIC Act that AFCA asserts underpin commercial lending and which , in our view, have been written for very different application than that proposed by AFCA.

We do not believe that external dispute resolution is the correct mechanism to facilitate commercial dispute resolution. This position is supported by the primary legislation of the Corporations Act and National Consumer Credit Protection Act which both establish licensing regimes for dealing with retail investors and consumers and mandate EDR membership for entities dealing with retail investors and consumers.

Commercial disputes should be heard by courts where proper process is followed, rules of evidence are abided and where the plaintiff must first establish a cause of action and a case to answer before a defendant is put to significant expense to defend a claim. Moreover, costs usually follow the event such that a party that is found to have done no wrong is given relief from costs.

In contrast, an AFCA claim can be brought by a complainant on the thinnest of material. Immediately on receipt of a claim, a defendant is put to proof to adduce all documentation and evidence in its possession to attempt to prove its innocence. A complainant is often required to produce little evidence and in addition to using the complaints process to avoid repaying loans or frustrate legitimate recovery on debts, complainants can be awarded sums for hurt feelings.

One example where EDR is being exploited by commercial borrowers and where AFCA is failing to differentiate between rights and obligations that apply to consumer and commercial borrowers is the ability to lodge a hardship notice as a consumer right created by the National Credit Code.

While hardship remains a consumer right, AFCA gives consideration to whether a commercial lenders should grant a hardship variation. It does so arguing that reasonable and product banker might do so, despite there being no agreed framework around such practice.

We are concerned with AFCA's proposed interpretation of s12ED of the ASIC Act that it somehow grants commercial borrowers the same rights as consumers because the warranty implied by s12ED mirrors the NCCP rights for consumers. The body of case law involving the application of s12ED of the ASIC Act is very limited.

Section 3: How we decide if a financial firm has met its lending obligations

1. Do you have any comments about our proposed approach to assess whether a small business loan is appropriate?

We hold concerns around the lack of established precedent for what constitutes an "appropriate loan" in the commercial space and the lack of clear law around what inquiries a lender must undertake when offering commercial loans. In the absence of a clear legal framework, we are concerned that AFCA is attempting to parallel the consumer regime by interpreting nebulous provisions of the ASIC Act in a manner that replicates the NCCP Act.

We are extremely concerned that the proposed approach has the effect of holding commercial lenders liable to underwrite the business risks of the borrower. Without small business finance, start-ups, speculative businesses and people pursuing their passion through taking a business risk are not possible.

A commercial lender should never be put in a position where it can be accused of failing to lend appropriately where a business has failed through the incompetence or inexperience of the borrower or where they have misjudged their market. Opening AFCA to more commercial disputes is likely to lead to this outcome. Regardless of whether a complainant is successful, a commercial lender can be drawn into a commercial dispute which will cost them more than $10,000 to defend.

It is relatively easy to frame a complaint in language that provides sufficient grounds for AFCA to hear it. The example provided in the consultation paper under Case Study 7 highlights this. In that case a commercial borrower levelled complaints about the lender acting unreasonably in asking for additional financial information about the company. They also disputed the loan term. AFCA needs to undertake certain inquiries in order to satisfy itself that it can close a complaint. This has the effect of AFCA drawing out potentially out-of-jurisdiction matters while it decides what approach it may take.

In this example, AFCA "reviewed all available information including the original loan contact, variation letters and all file notes" before determining the lender had acted reasonably. Case Study 7 does not give reassurance to industry that AFCA determinations are balanced or fair. The lender in

this matter still had to go through the complaint process and the lender was required to deliver all of their records to AFCA for review. This is a complete reverse onus of proof. The lender would have been charged AFCA fees for the determination.

We are concerned that the approach identified above may have the effect of awarding compensation to a complainant where AFCA finds any shortcoming with the lender's conduct. AFCA equates an adverse observation with a right to compensation without determining causation.

We maintain that the courts are the more appropriate forum to determine commercial disputes. This is particularly the case with small commercial disputes. In small commercial disputes each party bears its own costs. AFCA charges the financial firm around $10,000 for a dispute that proceeds to determination which creates a financial barrier preventing financial firms defending low value complaints. This includes complaints relating to hardship decisions and credit inquiry removals where the dispute is not over a sum of money but the outcome of certain conduct by the lender.

We raise a concern around the thinking that underpins the statement on page 18 of the consultation paper "AFCA generally considers that it is good industry practice for a firm to undertake some assessment about the small business's capacity to repay". Lenders do not lend money in circumstances where they have not weighed the prospects of getting the money back. The concern we have is that every lender may arrive at their decision based on consideration of different information. Not all borrowers will succeed in business. More than 50% fail in the first three years. We are extremely concerned that AFCA's foray into commercial lending will result in the scheme being abused and there being a high degree of inconsistency based on the lack of clear legal framework and legal precedent.

We cannot have a dispute resolution system where the decision maker has unfettered opportunity to reach a different decision to that of the lender based on them placing weight on different factors to those considered by the lender. Commercial lenders have a broad range of approaches. Lenders place different weight on propensity, past credit conduct, assessment of the current market and where a business proposes to position itself. Some lenders lend on blue sky projects. A lender could extend a dozen loans based on the same consideration for each. Many of the loans may perform well. Some will not. In most cases, the outcome will be a function of market risk rather than lender failure. We are concerned that AFCA, when faced with a complaint from a failed business, that it has too much latitude to conclude that a financial firm could have made a different lending decision by weighting or taking into account different criteria.

2. Do you have any comments about the non-exhaustive list of factors on page 19 that we may consider were appropriate for a financial firm to obtain or consider during their lending assessment?

We are concerned by the implications of many of the "relevant" factors identified by AFCA on Page 19. Most appear stacked against the financial firm. It appears that AFCA could draw an adverse inference against a financial firm for failing to consider any of these issues, or consider them in enough detail, or interrogate the validity of conclusions reached by the financial firm when it did consider the matters.

Looking through the non-exhaustive factors in the list, it is worrying to see a number of 'factors' that AFCA might give consideration to. This has the effect of AFCA putting itself in a position to retrospectively decide that certain matters should have been taken into account despite lenders being under no legal obligation to do so. In a dispute with a commercial borrower, will AFCA respect the inquiries and the decision made by the lender or will the AFCA decision maker draw up their own list of the factors they would have taken into account? Those we believe have no place in the decision framework of AFCA include:

a) How much weight was put on the business plan of a proposed borrower;
b) Considering what income is needed to "fund the owner's lifestyle";
c) Considering economic cycles;
d) Industry outlook and market conditions particular to the relevant sector;
e) Income about the director's income, liabilities and household expenses;
f) The presence and involvement of third-party advisers retained by the borrower

AFCA indicates that it may consider whether the financial firm considered the business plan of a proposed borrower before offering finance. Will it draw an adverse inference against the financial firm if it did not? Such an approach would make it incumbent on a financial firm to demand a business plan and then weigh the prospects of success of a commercial borrower before offering finance. This has wide-ranging implications. While a lender may wish to inform itself of a business plan, it is not a requirement that creates an industry standard. It is not adequate to assert that it is "good business practice".

Not all lenders will consider a business plan. Not all borrowers will have a business plan. A lender is not underwriting the prospects of success of a business borrower or ratifying a business plan merely by offering finance. This approach leaves the door wide open for a failed business to lodge a complaint against a financial firm for failing to consider the likelihood of success of the borrower. Such a complaint merely needs to allege a breach of an implied warranty to exercise due care and skill when assessing the borrower's prospects of servicing/repaying the loan. The AFCA process being what it is, the financial firm would then need to prove it did enough to satisfy the decision maker that it exercised due care and skill – meanwhile the decision maker's perspective is already coloured by the fact that the business failed or the borrower defaulted which "proves" the borrower could not service the loan. This is completely open to abuse. Regardless of the outcome, AFCA derives fee revenue from the ability of a borrower to lodge a complaint.

If an adverse conclusion may be drawn against a lender for not considering a borrower's business plan, this could lead to a situation where the only way a commercial lender can protect themselves from future claims will be to require every commercial borrower to have a business plan. If a commercial lender risks an adverse finding for failing to identify weaknesses in a business plan, then this could lead to commercial lenders requiring every commercial borrower to obtain independent certification that the business plan is meritorious. All of this works against the Government's objectives to reduce red tape and facilitate access to credit for small business. The approach, as it is currently positioned, indicates that adverse findings may be made against a financial firm where it:

a) Does not consider a business plan; or
b) Where it considers the business plan but fails to interrogate the risks of the business

3. Do you have any comments about the list of common warning signs on page 24 that AFCA may consider should prompt a financial firm to make further inquiries during the credit assessment process?

Commercial loans are not subject to the responsible lending obligations to make reasonable inquiries into a consumer's requirements and objectives or to take steps to verify the consumer's financial situation. While most commercial lenders will make inquiries, what inquiries they make and how much weight they place on particular matters will vary significantly. Paramountcy must be given to the decision by Government to exclude commercial loans from the consumer framework and we believe the appropriate lending framework moves too far into a faux regulatory regime for commercial lending.

Several issues present themselves from the list on page 24 of the paper.

Many of the further inquiries identified in the list on page 24 appear to relate to matters the borrower should have informed themselves of rather than the lender. A lender is not embarking on a business venture with the borrower. The lender is merely providing finance to enable a borrower to undertake commercial risk for gain. More than 50% of all businesses will fail in their first 3 years of operation. We are concerned that AFCA staff, with their consumer protection mentality, will struggle to differentiate between a failed business and a lender that has facilitated it by providing finance. Correlation and causation are frequently confused. Irresponsible lending and business failure can both result in the same outcome – a dissatisfied borrower lodging a complaint with the EDR scheme. We are also extremely concerned that AFCA's approach will increase the number of complaints against commercial lenders and will be charged for them regardless of fault.

How does AFCA determine whether the presence or absence of specific circumstances can be attributed to the success or failure of a business at the time a lending decision is made? With the benefit of hindsight it may be easy to identify why a business fails, but a lender does not have the benefit of hindsight when making real-time decisions when the applicant's business has not yet commenced or appears to be performing well.

We do not support the approach identified in the list of possible further inquiries that AFCA considers may be appropriate.

We are extremely concerned that AFCA would consider that a lender might need to make additional inquiries regarding cash flow projections where those projections are provided by a business adviser[2]. This very strongly indicates to us that AFCA's understanding of the role of a lender is misinformed.

We highlight a further concern with the position expressed on page 28 where AFCA writes "AFCA will consider if a financial firm provided funds in circumstances where they knew, or should have known, **the use of the funds was risky or likely to cause the small business loss**". Risk is the heart of small business. A failure to understand this demonstrates that AFCA staff do not have the

[2] AFCA Consultation Paper page 27.

necessary skills and experience to hear commercial complaints and will be unable to reach impartial conclusions when faced with the evidence of the complainant's failure.

Section 4: How we determine fair outcomes and calculate loss

4. Do you have any comment about our proposed approach to calculating loss and determining fair outcomes?

It is concerning that a consumer ombudsman is hearing disputes involving amounts of money that can exceed the monetary jurisdiction of the District Court. One of the examples involves a loan of $950,000. We cannot envisage any situation where it is appropriate for AFCA to rule on such sizeable matters. More sensibility is required as to jurisdiction and such matters should go before the courts.

It appears AFCA gives very little consideration to the conduct of the complainant. While AFCA claims that a financial firm is (usually) not liable for loss caused by business decisions, this statement is difficult to reconcile against additional factors that AFCA will consider against the lender's lending decision such as whether the borrower had a business plan, whether that business plan was realistic and whether the borrower had a business adviser.

Other feedback

5. Do you have any comments about the examples provided in the Approach? Are there other examples you would like to see in the Approach?

We have provided comments against the examples in other parts of this submission.

6. Do you have any comments about our use of the phrase "appropriate lending" as a description of the standard to be applied for small business lending?

This phrase is not widely used outside AFCA, but we wanted to find and use a phrase to describe small business lending that was different to "responsible lending" (which applies to loans to consumers) and "unregulated lending" (because small business lending does have regulations).

We consider the term unregulated lending to be the most appropriate – because that is what it is. Lending that is unregulated by consumer credit protection legislation and where there is very little judicial consideration of broader provisions under the ASIC Act.

We do not support the term *appropriate lending* because the term is not defined and it is extremely subjective. Is it *inappropriate* to fund a blue sky venture that ultimately fails? We say it is not, but have concerns that AFCA's framework might hold a lender accountable for the outcome.

The term "appropriate lending" is not used widely outside of AFCA because it is a construct of AFCA. The term *appropriate* lending is a conclusion reached by AFCA rather than any objective standard of behaviour that applies to a largely unregulated activity.

7. Do you have any other feedback about changes that could be made to the draft Approach to better achieve our objectives?

AFCA's objectives should be to provide a consumer redress scheme for consumer loans. It is concerning that AFCA has "objectives" in relation to creating a new regulatory regime for unregulated lending. It is not necessary and AFCA should confine itself to *consumer credit* as it is defined in the NCCP Act.

We are concerned that different rules are to be applied to different financial firms depending on whether they are a signatory to a particular industry Code. We do not believe that such an approach is sustainable or capable of being executed consistently. It is likely that common considerations will be applied across all commercial disputes which will result in particular Code standards being applied to all commercial firms with indifference. Alternately, where the Code does not apply, the same standards of conduct will be applied for the ease of the decision maker and instead of basing a decision on Code requirements it will be described as "good industry practice". Given that decisions cannot be appealed we consider this approach to be unworkable for industry and excessively complainant biased.

We do not support AFCA's push into the commercial lending space as it has proposed through this approach.

Yours faithfully

Peter J White AM MAICD
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