The AFCA Approach to Lending to Small Business

Australian Financial Complaints Authority

January 2024

AFCA Approach documents help consumers, small businesses and financial firms to better understand how AFCA reaches decisions about key issues.

These documents explain the way we approach common issues and complaint types. However, it is important to understand that each complaint that comes to us is unique, so this information is a guide only. No determination (decision) can be seen as a precedent for future cases, and no AFCA Approach document can cover everything you might want to know about a key issue.

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1 Executive summary

1.1 AFCA's purpose

AFCA is the independent external dispute resolution (EDR) scheme for the financial services sector. AFCA's purpose is to provide fair, independent and effective solutions for financial disputes. We do this by providing fair dispute resolution services. We also work with financial firms to improve their processes and standards of service to minimise future complaints. In addition to resolving financial complaints, AFCA identifies, resolves and reports on systemic issues and serious contraventions of the law.

1.2 About AFCA's approach documents

The purpose of AFCA's approach documents is to explain how we look at common issues and complaint types. Approach documents provide greater clarity around what to expect from AFCA processes, explain how we investigate complaints and how we make decisions.

1.3 What is the purpose of this Approach?

This document outlines our approach to complaints made by small businesses, about credit provided to them for business or investment purposes (other than investment in a residential property by an individual). The Approach covers lending that is not regulated by the *National Consumer Credit Protection Act* 2009 (Cth) (National Credit Act), often referred to as unregulated lending. There are laws that regulate a financial firm's conduct when lending to small business, such as the ASIC Act, so lending to small business is not unregulated. AFCA uses the term appropriate lending in this Approach to refer to whether a financial firm has appropriately provided credit to a small business considering laws, any applicable codes and good industry practice that apply to it.

This Approach explains how AFCA assesses whether credit was appropriately provided. It includes how AFCA:

- assesses a financial firm's compliance with lending obligations that may apply to it such as legal principles, industry codes and regulatory guidance
- calculates loss and assesses benefits to determine compensation
- applies its fairness jurisdiction to determine an outcome that is fair in all the circumstances of the complaint.

This Approach is intended to be informative and explain common issues we may consider in appropriate lending complaints. It is not definitive or exhaustive, and it does not create any new obligations.

There is a broad range of small business credit products and financial firms, and it is not possible to address each specifically in this Approach.

We consider each complaint on its unique facts and circumstances. Where we discuss factors we may consider, or where further inquiries may be warranted, not all of these factors will apply to every complaint.

1.4 Who should read this Approach?

Financial firms | **Small businesses** | **Guarantors of small business loans**

This Approach is for financial firms, small businesses, guarantors of small business loans and anyone who wants to understand how AFCA applies legal principles, industry codes and guidance, and good industry practice when considering complaints about appropriate lending to a small business.

1.5 About appropriate lending complaints

AFCA uses the term ‘appropriate lending’ to describe complaints we receive about a financial firm’s decision to lend to a small business. When considering appropriate lending complaints, we consider the laws and codes that applied to a particular financial firm when it made the lending assessment. The obligations will be different depending on the type of financial firm, credit product and how the product is distributed. This Approach does not create new obligations. As explained above at 1.3 we use the term ‘appropriate lending’ to distinguish the obligations that may consider in small business lending from the responsible lending obligations owed under the National Credit Act.

Important note: There is a significant difference between the obligations of financial firms lending to a small business compared to a consumer.

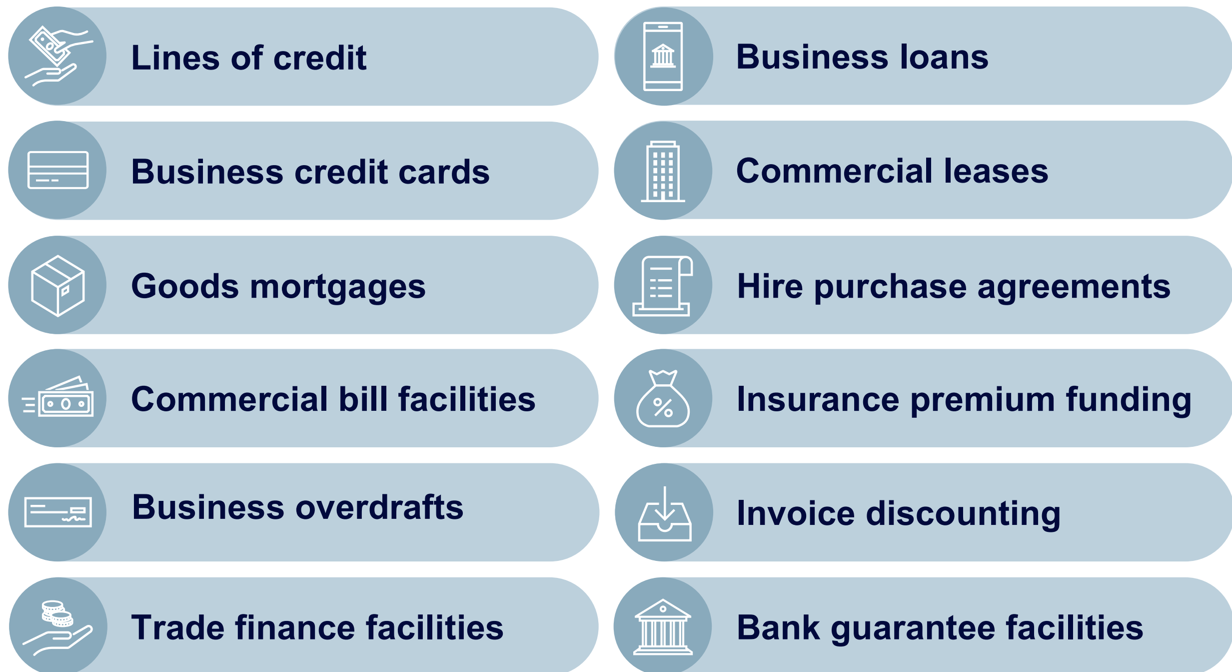
Credit provided wholly or predominantly for a business purpose, or for an investment purpose (other than lending to an individual for residential investment purposes), is not subject to the National Credit Act and ASIC’s Regulatory Guide 209.[1]

[1] Reg 28RB of the National Consumer Credit Protection Regulations (2010) may modify the application of parts of the National Credit Act where credit is provided to an individual for the purposes of a small business and it is not merely minor or incidental.

Appropriate lending complaints include claims that:

- credit should not have been provided, for instance because the small business could not meet the required repayments or repay the loan when required
- the credit facility did not meet the purpose disclosed by the small business.

Common types of small business credit products include:



The above list includes the main types of products we see in complaints to AFCA, but it is not exhaustive. Different financial firms use different names for their products, even if the underlying product operates in a similar way. Throughout this Approach, AFCA uses ‘credit’ to refer to all types of products like those listed above.

It is important to understand that each AFCA complaint has a unique set of facts, and this information is a guide only. We will always consider all the circumstances of a complaint and the impact of the issues on the parties to determine an outcome that is fair in all the circumstances.

AFCA supports good commercial practice in the assessment and provision of credit to a small business. We also support financial firms improving their processes and standards of service to minimise future complaints.

2 How we assess appropriate lending complaints

2.1 Defining small business

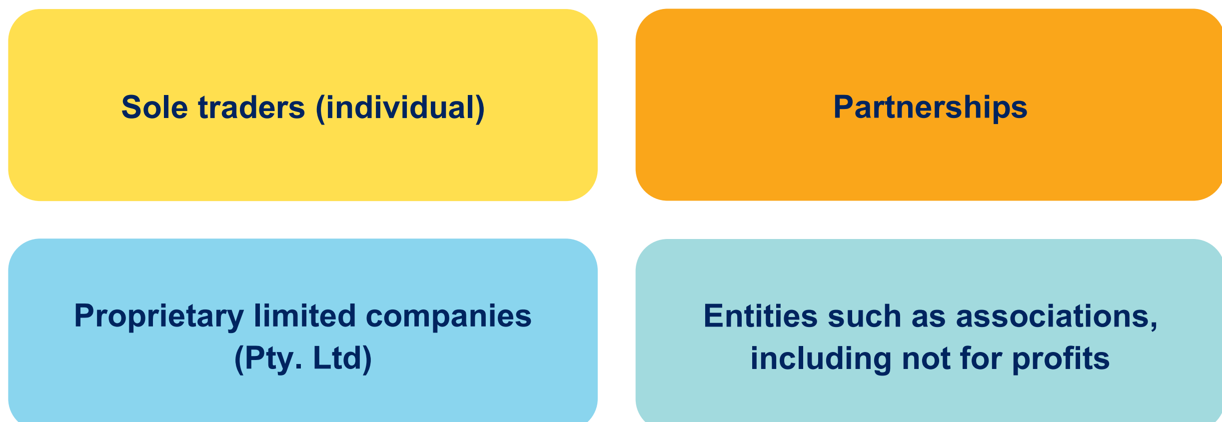
When we receive a complaint from a small business about appropriate lending, we first consider if the complainant is a ‘small business’ under our Rules.

AFCA’s Rules define a ‘small business’ as a business (or a group of related bodies corporate) with less than 100 employees. A small business may be a primary producer.

Industry codes and legislation have different definitions of small business. We will only consider those codes or laws if a small business meets the definition of small business under that code or law. For example, if a small business meets the definition under the *Australian Securities and Investments Commission Act* 2001 (Cth) (ASIC Act), we will consider whether the financial firm complied with any relevant provisions under the ASIC Act when assessing the complaint.

Types of small business entities

Small businesses can be:



Companies or individuals can operate a small business in their own capacity, or as trustees for family or other trusts. If the complainant does not operate a business, it may still be eligible to bring a complaint under our Rules if it is:

- an individual trustee of a trust; or
- the corporate trustee of a Self-Managed Superannuation Fund (SMSF) or a family trust.

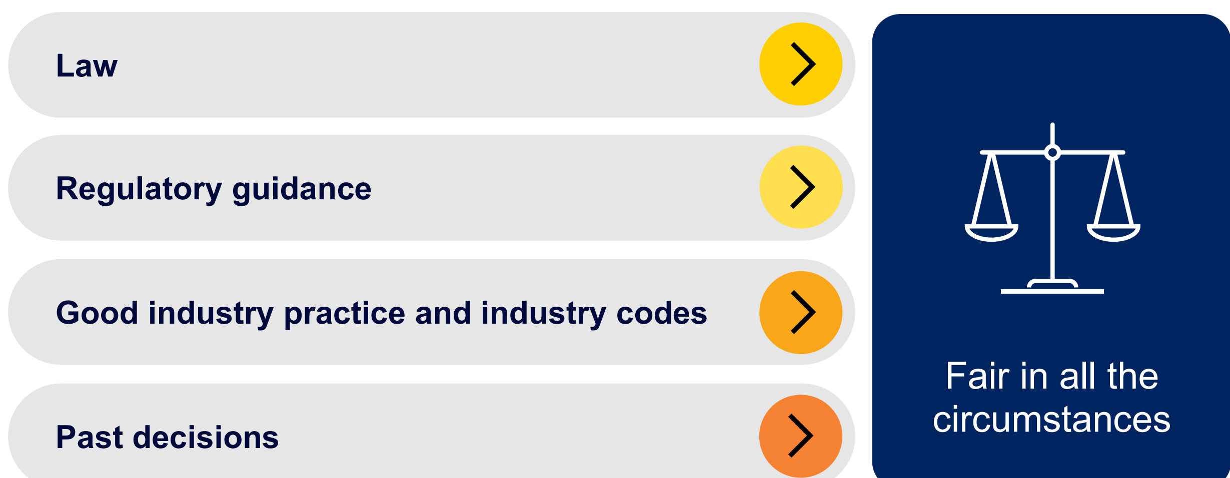
Identifying the correct small business complainant

We will ensure we are dealing with the correct small business complainant by understanding the structure of the small business.

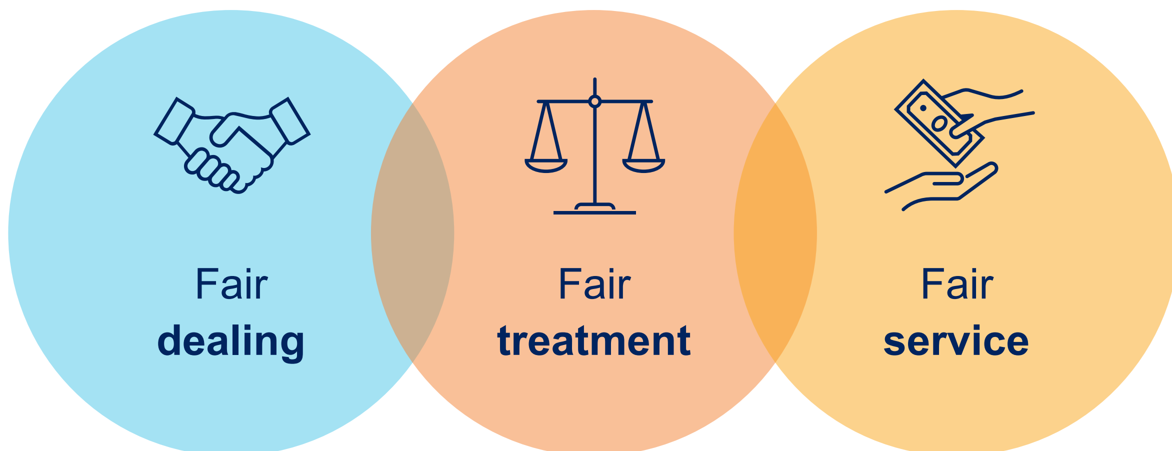
Individuals	A small business can be operated by an individual (sole trader, a trustee, or a partner). All are eligible to bring a complaint.
Partnerships	If the small business making the complaint is a partnership, or two or more entities operate the business, AFCA will generally ask all entities to bring the complaint. If only one partner brings a complaint, AFCA will consider why that is the case. There may be good reasons why the others are not part of the complaint, but AFCA may reduce any compensation it awards to take into account the complainant's share in the business.
Companies	If the borrower is a company, then normally that company should be the complainant. A company is a separate legal entity. Financial firms often require personal guarantees from directors and sometimes from shareholders. This means a director's or a shareholder's assets may be at risk if the company is unable to repay debt. In some circumstances a guarantor could also bring a complaint about the appropriateness of a loan to a company.

2.2 AFCA's fairness jurisdiction

When assessing the conduct of a financial firm, our Rules require us to have regard to the law, codes, and standards of industry practice that were in place at the time of the conduct.



Our Rules require our decisions to reflect what is fair in all the circumstances of each complaint. In assessing what is fair, we focus on concepts such as fair dealing, fair treatment, and fair service.



This allows us to assess a complaint about conduct of a financial firm leading to the provision of credit, and any increases in amount or limit with its customer.

We may decide a financial firm must compensate a small business for direct, indirect or non-financial loss.[2] We may also decide a financial firm needs to take, or refrain from taking, particular actions. If a small business accepts our final decision, the financial firm is bound by that decision.[3]

The primary focus of our investigation is to assess whether in providing credit, a financial firm failed to comply with any law or code that applies to it which caused the complainant to suffer loss or harm. We look at what occurred at the time the credit was provided. We also consider the conduct of the parties when determining a fair outcome.

2.3 What small business complaints can AFCA consider?

Under our Rules, AFCA can accept a broad range of complaints by a small business relating to credit provided by a financial firm.

Complaints against AFCA members

AFCA can consider complaints against financial firms that are AFCA members, provided the complaints meet the other requirements in our Rules (for example rule A.4).

[2] See AFCA Rule D.3.
[3] See AFCA Rule A.15.3.

Not all financial firms that provide credit to small businesses are AFCA members. Examples of non-members may include asset leasing businesses and online and private equity lenders where credit is only provided to business customers.

Small businesses and guarantors can check whether the financial firm is a member of AFCA at www.afca.org.au/find-a-financial-firm.

Complaints that have been through a farm debt mediation process

AFCA can consider a complaint about appropriate lending brought by a farmer, even if that farmer has been through the applicable state-based farm debt mediation (FDM) process, if a:

- farmer and financial firm did not reach agreement in the mediation
- farmer experiences new financial difficulty which was not the subject of an agreement in the mediation
- financial firm has not complied with the terms of settlement
- complaint relates to a financial service (for example a farmer's transaction account) that was not part of the mediation.

Under our Rules, we cannot consider a complaint that has already been dealt with and resolved by FDM. Where an FDM settlement agreement has been executed by the parties, AFCA will need to see a copy of the mediation agreement to ensure the substance of the complaint lodged at AFCA has not been resolved by FDM and is not linked to the matters already resolved.

Other matters impacting the right to bring a complaint to AFCA

Where a small business is not an individual, AFCA may require the individual bringing the complaint to obtain the authority of the entity operating the business to bring the complaint.

For example, if a director brings a claim to AFCA in the name of a company, it will need the consent of the company. In certain circumstances, AFCA may need information or consent from a third party to consider a complaint from a small business.

If a small business is operated by a company:

- and the company is in liquidation or administration (or goes into liquidation or administration after a complaint is lodged), then AFCA generally requires the written authority of the liquidator or administrator to deal with a complaint on behalf of the company
- and the company is deregistered, then it has ceased to exist and AFCA cannot accept a complaint from it. In this circumstance, ASIC becomes the owner of its non-trust property and the Commonwealth becomes the owner of its trust property

- AFCA may be able to accept complaints from guarantors of a company in liquidation or administration, or a company that has been deregistered, depending on the circumstances.

If a small business is operated by an individual as a sole trader or in a partnership:

- and the individual is bankrupt (or is discharged but had been bankrupt after the conduct to which the complaint relates, or became bankrupt after the complaint is lodged), then AFCA may require written authority of the trustee in bankruptcy.
- and the individual has died, then AFCA may be able to accept a complaint from the deceased's executor and administrator.

Guarantors

A guarantor of a small business credit contract may also make a complaint. This Approach also covers how AFCA considers guarantors in an appropriate lending complaint.

Some Industry codes have specific provisions relating to guarantors. If a financial firm is a signatory to a code, we will consider any relevant obligations about guarantors that apply to it under that code.

We also have an Approach document for complaints lodged by guarantors which should be read alongside this Approach.

2.4 Complaints not covered by this Approach

Credit products regulated by the National Credit Act

This Approach does not apply to credit regulated by the National Credit Act. The obligations on financial firms lending to a small business are different to those that apply to consumer lending. See AFCA's Approach to Responsible Lending for information about our approach to responsible lending and consumer credit.

Important note: As noted in section 1.4. there is a significant difference between the obligations of financial firms lending to a small business compared to a consumer. Credit provided wholly or predominantly for a business purpose, or for an investment purpose (other than lending to an individual for residential investment purposes), is not subject to the National Credit Act and ASIC's Regulatory Guide 209.[4]

[4] Reg 28RB of the National Consumer Credit Protection Regulations (2010) may modify the application of parts of the National Credit Act where credit is provided to an individual for the purposes of a small business and it is not merely minor or incidental.

Complaints excluded by our Rules

AFCA's Rules may exclude a complaint brought by a:

- small business when the credit facility exceeds the applicable monetary limits under our Rules[5]; and/or
- small business that is not an Eligible Person under our Rules.

There are other exclusions that may apply which are set out in Section C of our Rules.

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

3.1 General considerations

How AFCA reviews a financial firm's lending decision

When assessing complaints, our focus is to consider the obligations owed by the particular financial firm, and whether the credit contract was appropriate for the small business. We will review whether a financial firm complied with their obligations when carrying out the credit assessment process based on any information we consider to be relevant, and in accordance with our Rules. We will also consider what the small business asked for, including what it said it would be using the product for and any particular product features it requested.

When we provide examples illustrating how we consider different complaints, the examples are illustrative only. For example, where a case study refers to particular information we consider a financial firm should have obtained in a lending assessment, this does not mean obtaining that information is mandatory, or is the only way a financial firm can meet its obligations. This Approach does not prescribe or require financial firms use any particular technology or methodology to meet its obligations.

[5] See AFCA Rules C.1.3(b) for the current limit.

In reviewing a financial firm's lending decision, AFCA will have regard to:

- the financial firm's obligations at the time of the lending decision;
- the financial firm's process for reviewing a proposal and the factors it considered. AFCA recognises that financial firms use a range of credit assessment systems including online and manual processes;
- information that was reasonably available at the time, including about resources available to the small business;
- if the financial firm should have known information or sought further information because the application included circumstances or information that should have prompted further inquiry; and
- the financial firm's lending policies, if relevant.

Different types of credit may require different inquiries and considerations in the credit assessment process.

Considering lending decisions at the time they are made

AFCA does not use the benefit of hindsight to assess lending decisions. We consider the law and standards that applied when the decision was made, including the in-force versions of any relevant codes, and good industry practice at that time.

If the financial firm has breached its obligations to the small business, we consider whether the small business has suffered loss.

How we determine fair outcomes

Our Rules require our decisions to reflect what is fair in all the circumstances of each complaint. In assessing what is fair, we apply a standard of fairness which focuses on concepts such as fair dealing, fair treatment and fair service.

We will consider all the circumstances, including the behaviour of the parties, to determine an outcome that is fair to the parties.

Steps we take in our investigation

When we investigate appropriate lending complaints, we consider whether the financial firm complied with its obligations.

To do this, we usually take the following steps:

1. **Gather information** from the parties provided in the lending process.
2. Consider the financial firm's **obligations under laws and codes, and good industry practice**.
3. Consider the **purpose and features** of the credit facility.
4. Review the financial firm's **credit assessment**.
5. Consider if there were warning signs or unusual circumstances that required the financial firm to make **further inquiries** or request **further information**.
6. Consider any **additional matters** that may be relevant to our decision, which will be different depending on the type of loan and lender.

3.2 Information we request from the parties

During our assessment, we will ask for information from both parties to help us understand the complaint. Under our Rules, parties are generally required to comply with AFCA's information requests.

Financial firms should provide AFCA with an explanation of the process it followed in making their credit assessment, supported by references to other documents or information used. For example, if the financial firm uses an online credit assessment system, the financial firm should explain to AFCA how its system approved the loan (this might include explaining the information and business rules it applied to approve the loan). This helps AFCA assess whether a financial firm met the obligations that apply to it.

If any code applies, we will seek information to understand whether the process any assessment system followed complies with the code in assessing the loan.

For example, if a financial firm is a signatory to the AFIA Online Small Business Lenders Code of Practice and the credit product is one to which the code applies, AFCA expects the financial firm to explain how its credit assessment system complied with clause 15 (if the 1 December 2022 version of that code is the relevant version applicable) including whether it assessed the capacity of the small business to repay when required.

Where a party fails to provide information to AFCA on request, (for example, if a financial firm does not provide information about how its online credit system assessed the loan) or does not provide relevant sections of lending policies, we may draw an adverse inference (that is, we may assume the information is unfavourable to the party's position) unless special circumstances apply. In some cases, we may be unable to continue investigating the complaint.

Where a financial firm claims that information cannot be shared with the small business because it is commercial in confidence, we may not be able to rely on it in our decision making, unless special circumstances apply.

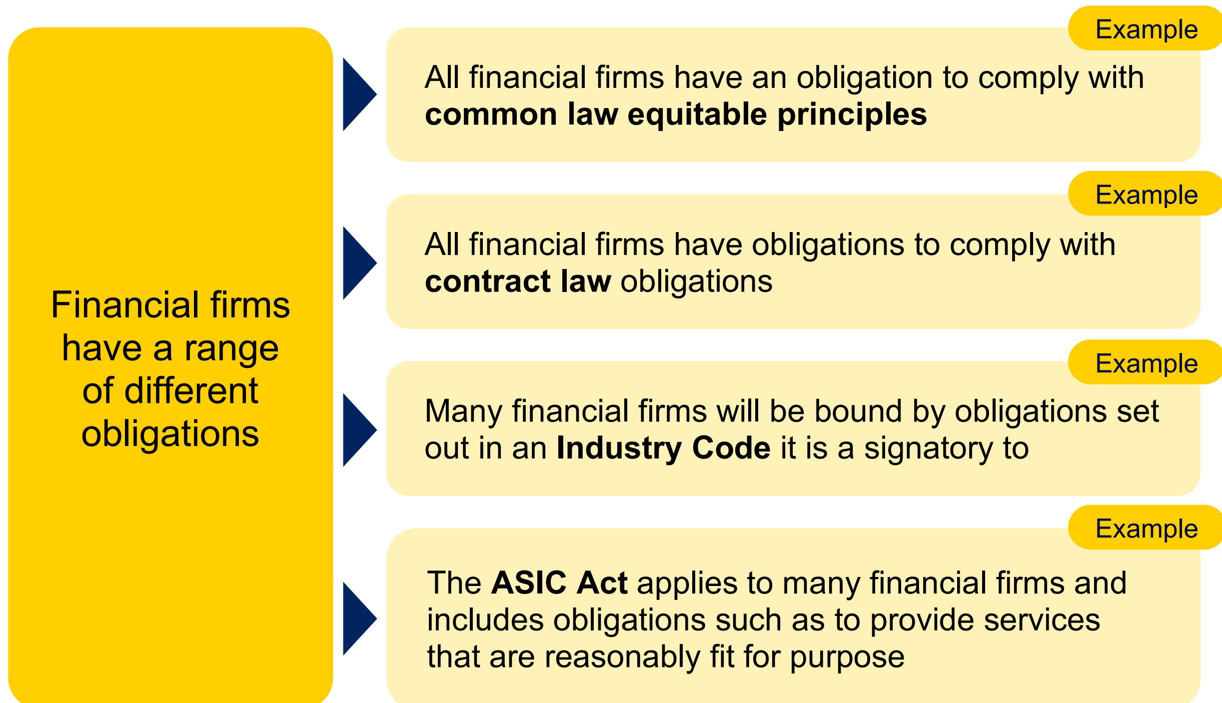
AFCA will also ask the complainant to outline their concerns about the lending assessment. We may ask for an explanation about the information it supplied to the financial firm at the time of the lending assessment.

3.3 Consider the financial firm's obligations and good industry practice

Financial firms that provide credit to small businesses may have a range of different obligations under laws and industry codes. This section sets out the key obligations that we may consider in appropriate lending complaints and how we consider good industry practice.

While all financial firms will have obligations under contract law and equitable principles, many firms will have additional obligations under legislation, industry codes, or good industry practice. For example, a financial firm that was a signatory to the 2013 Australian Banking Code of Banking Practice (ABA BCOP) would have had an obligation to act as a diligent and prudent banker when lending to a small business which required them to assess whether the small business can repay the loan (under clause 27)[6].

6 See, for example *National Australia Bank Ltd v Smith [2014] NSWSC 1605, Doggett v Commonwealth Bank of Australia [2015] VSCA 351, Bank of Queensland v Edwards [2017] QSC 191, Haynes v Westpac Banking Corporation (2018) 130 SASR 551, Fuge v Commonwealth Bank of Australia [2019] FCA 1621, Bendigo and Adelaide Bank Limited v Brackenridge [2020] SASC 114, Gooley v NSW Rural Assistance Authority [2020] NSWCA 156, Dinh v Commonwealth Bank of Australia [2021] WASCA 127, Gardiner v National Australia Bank Ltd [2023] NSWC 45*



In each case, AFCA will consider what obligations apply to the financial firm depending on the category of firm and type of credit product that is subject to the complaint. AFCA will review whether it breached those obligations when providing the credit and caused the small business loss.

We may look to past decisions made by AFCA or predecessor schemes, which are not binding but are taken into account for consistency in decision making.

Legislation and case law

In our decisions, we will consider legal principles and equitable principles that arise from court decisions dealing with contractual principles or negligence. Common law and equitable principles are created through the decisions of judges, compared to law that is written in legislation.

Equitable principles can assist in providing compensation to a borrower, for example where there has been misleading or unconscionable conduct by the financial firm that has caused them to suffer loss[7].

7 For example, the High Court of Australia recently decided that a business loan made to a borrower who lacked commercial understanding, who did not receive independent legal advice, and for whom default in repayment was ‘inevitable as a matter of objective fact’, was unconscionable. Stubbings v. Jams 2 Pty Ltd [2022] HCA 6

Example

Inappropriate loan due to unconscionable conduct

Pia had been unemployed for several years and lived in a home her aunt left her. She was persuaded to start a food truck business by a friend who was a loan manager at a non-bank lender. Pia had no previous business experience.

The non-bank lender offered to loan Pia $100,000 over a 12-month term. The loan was secured against Pia's home. It did not ask Pia for any information about her business or income. Pia signed the contract despite having no income at the time.

Within one month Pia defaulted on the loan, and the lender sought to take possession of Pia's home. Pia complained to AFCA.

AFCA found that as the lender was not a signatory to an industry code, there was no requirement, for example, for it to act as a diligent and prudent banker.

However, AFCA determined that if the lender had made any assessment, it would have determined that Pia was unable to repay the loan without selling her home.

AFCA also determined that the lender had engaged in unconscionable conduct by entering into a loan with Pia that:

- did not involve Pia obtaining independent legal or financial advice;
- was secured against Pia's home; and
- took advantage of her as it was made in circumstances where, if it had made inquiries, it would have known Pia had no income, was more than likely to be unable to repay the loan and would likely lose her home.

Australian Securities & Investments Commission Act 2001

Financial firms that provide credit to a small business may be subject to obligations under the ASIC Act. If the financial firm does not meet these obligations, AFCA will consider if that has caused the complainant loss. The ASIC Act has a more restrictive definition of a small business than AFCA. AFCA will only consider any obligations owed under the ASIC Act where the small business meets the definition of a small business under the ASIC Act.

We may consider the following obligations under the ASIC Act, where it applies:

Due care and skill

- the statutory warranty to provide services with due care and skill (s 12ED(1)(a)).
  > *this warranty only applies to financial services as defined in the ASIC Act and to the conduct of a lender after the loan contract has been entered into. It does not apply to the lending decision, although other standards may apply.*

Reasonably fit for purpose

- the statutory warranty that the financial services provided will be reasonably fit for the purpose or desired result that the small business makes known to the financial firm, expressly or by implication (s.12ED (2))
  > *This may be relevant where a small business says the type of loan, or its features, did not meet its requirements. For example, if a small business requested an overdraft facility but was provided with a term loan facility.*

Unconscionable conduct

- the prohibition against engaging in unconscionable conduct (s12CB(1)(a))

Misleading and deceptive conduct

- to not engage in conduct that was misleading or deceptive, or likely to mislead or deceive (s.12 DA(1)); and

Unfair contract terms

- unfair contract terms (s.12BF to s.12BL). We will consider whether relevant contract terms are likely to be unfair when determining what is a fair outcome in all the circumstances.

Industry codes

Many small business lenders are signatories to industry codes of practice that apply to their small business lending.

When determining an appropriate lending complaint, we will consider if the financial firm has complied with any relevant industry code it has subscribed to including the following, which are linked at the end of this document:

- Australian Banking Association's Banking Code of Practice (ABA BCOP)
- Customer Owned Banking Association's Customer Owned Banking Code of Practice (COBA BCOP)
- Australian Finance Industry Association's Online Small Business Lenders Code of Practice (AFIA Online Code)
- Australian Finance Industry Association's Insurance Premium Funding Code of Practice.

If the financial firm was a signatory to an industry code at the time of the credit assessment, we will consider whether their credit assessment complied with any requirements set out in the version of the code that applied at that time.

For example, if the financial firm is a signatory to the ABA BCOP and the conduct complained of occurred in 2022, we will consider if the financial firm has exercised the care and skill of a diligent and prudent banker when providing credit to a small business or increasing a credit limit. We can also consider for a guarantor if the financial firm exercised the care and skill of a diligent and prudent banker in assessing the small business's ability to repay the loan.

AFCA may consider some principles in a code reflect good industry practice within a particular industry sector. We expect lenders to comply with these principles even if it is not a signatory to the code. This is because the principles represent good industry practice, not because they are in the code.

Good industry practice

When determining what is fair in all the circumstances, AFCA's Rules require it to also have regard to any applicable good industry practice. AFCA has developed a fact sheet, AFCA's Approach to Code obligations for credit providers, that should be read alongside this Approach.

We do not assess the conduct of financial firms against best industry practice. Where some market participants make commitments or develop practices that go above and beyond their obligations under law or codes, we may determine those commitments or practices are 'best industry practice' rather than 'good industry practice'.

There are a range of practices within different sectors of the credit industry that may be sufficient to comply with the law, some of which may not meet the standard of 'good industry practice'. It should also be noted that while a practice may have been adopted by industry at a particular time (that is, it was 'standard industry practice'), it does not mean that practice is 'good industry practice' or compliant with the law.

If an industry code does not apply, AFCA generally expects financial firms to undertake some assessment about how a borrower will repay the loan. For example, the assessment may be a borrower intends to repay the loan from cash flow, resources available to the borrower, re-finance or the sale of assets.

AFCA recognises that some business loans are 'pure asset loans'. These loans rely on the value of the assets that secure the loan without any reliance upon the borrower's ability to repay the loan from his or her income or other assets. In these cases, we will consider if the financial firm has complied with their obligations under general law and legislation such as to not engage in unconscionable conduct.

If a complainant considers a financial firm did not comply with good industry practice, we might ask the complainant to provide evidence to support that submission. In these cases, we will give a financial firm the opportunity to provide AFCA with information to explain whether its practice or process is good industry practice.

3.4 The purpose of the credit contract

The credit provided should be reasonably fit for purpose

Section 12ED of the ASIC Act requires that any contract for the supply of financial services (such as a credit product for a small business) must be reasonably fit for purpose.

AFCA expects a financial firm that is bound by the ASIC Act to ensure the credit product is reasonably fit for the purpose of the small business. Examples where we may consider the loan is not reasonably fit for purpose include:

- where a complainant asked for a bailment facility and an overdraft facility and was only given a bailment facility
- where a complainant asked for a term loan and was provided a bill facility.

Generally, we expect parties to a credit contract to read and understand the contract and documentation it signs when accepting a credit offer.

If a small business says the contract (or other document) is different to what they agreed or were told by the financial firm, we will consider the ASIC Act and equitable principles that may apply. For example, we may consider if the financial firm misled or deceived the small business or engaged in unconscionable conduct during the application process.

Considering if a business purpose declaration (BPD) is effective

If an individual enters a credit contract wholly or predominantly for a business purpose, a lender may require them to sign a BPD to confirm that the contract is for a business purpose and therefore not subject to responsible lending laws in the

National Credit Act. If the credit is provided wholly or predominantly for a business purpose the National Credit Act does not apply.[8]

A BPD is ineffective if a credit provider:

a) knew or had reason to believe, or would have known, or had reason to believe, if it had made reasonable inquiries about the purpose for which the credit was provided, or was intended to be provided, that the credit was in fact to be applied wholly or predominantly for a consumer purpose or to purchase, renovate or improve a residential investment property; or
b) the business purpose declaration is not in the correct form.

If we determine the BPD cannot be relied upon, we may consider the National Credit Act applies to the loan. If this occurs, AFCA may award compensation for any loss the borrower has suffered as a result of obtaining a business loan instead of a consumer loan. For example, the interest rate on the business loan may have been higher.

Example

Ineffective business purpose declaration

AFCA received a complaint from a borrower who signed a business purpose declaration for a car loan. The loan application stated the car would be used for driving to and from work as an employee.

AFCA assessed that the financial firm should have made further inquiries about whether the loan was truly for a business purpose, as without further explanation, 'driving to and from work' is not generally a business purpose.

AFCA determined that the business purpose declaration was ineffective, and therefore assessed the loan as a consumer loan under the National Credit Act.

If there is no business purpose declaration, the financial firm will have to establish the loan was for a business purpose, and not a consumer loan regulated by the National Credit Act.

3.5 Considering if the credit assessment was appropriate

AFCA will consider whether a financial firm made an appropriate credit assessment having regard to the obligations of that financial firm and good industry practice, as set out in section 3.3. As mentioned above, different firms have different obligations.

While all financial firms have an obligation to comply with the contract or equitable principles (such as to not engage in unconscionable or misleading conduct) most

[8] Reg 28RB of the National Consumer Credit Protection Regulations (2010) may modify the application of parts of the National Credit Act where credit is provided to an individual for the purposes of a small business and it is not merely minor or incidental.

firms will also have an obligation to assess whether the small business can repay the credit due to obligations in their industry code. As explained in 3.3, if an industry code does not apply, AFCA generally considers that it is good industry practice for a firm to undertake some assessment about the small business's capacity to repay.

When considering a financial firm's assessment process, we may have regard to:

- the type of financial firm
- the type of credit product
- the amount of credit
- any relevant internal credit policy
- the purpose of the loan (common examples may include to acquire a new business, to acquire an income producing asset or support cashflow needs)
- the characteristics of the borrower (which could include their experience, any vulnerabilities and whether the borrower engaged advisers)
- what information was supplied by the borrower and relied on by the financial firm
- how the small business applied for the loan (for example whether it was online or in branch).

The above list of factors is a guide only and is not exhaustive. It describes common factors that are relevant in credit assessments. It does not mean assessing these factors is mandatory for a credit assessment or is the only way a financial firm can meet its obligations.

The factors a financial firm considers in its assessment will likely vary depending on the type of credit product. For example, the factors a financial firm considers assessing a credit card will be different from those used to assess a loan for the construction of a large commercial property. We have included examples below to illustrate different types of information or circumstances a financial may need to consider in their credit assessment. These examples are for illustration only and are not intended to impose or imply a requirement for a financial firm to consider all or any of these factors during a credit assessment.

Online credit assessment

This example illustrates an online credit assessment process followed by a financial firm that AFCA considered was appropriate as the firm was a signatory to the AFIA Online Code.

Example

Appropriate online loan assessment

A small business operated a café and required a new refrigeration unit because its old one broke down. It sought a short-term loan for $7,000 to acquire the unit via the financial firms' online application portal.

The financial firm approved the loan after it:

- obtained details of the small business's monthly sales and requested loan amount;
- confirmed ATO tax payments were up to date;
- confirmed GST and ABN registration;
- confirmed a clear credit history;
- completed a satisfactory review of 6-months of the business' transaction account statements; and
- reviewed directors and business liabilities.

The financial firm was a signatory to the AFIA Online Code. AFCA determined the firm's assessment was appropriate and complied with their obligations under clause 15 of the Code because it held information about the business' financial circumstances that showed the business had capacity to repay the loan.

Inadequate cash flow forecast information

This example illustrates where information supplied to a financial firm who was a signatory to the ABA BCOP was not sufficient to support the conclusion that the small business could repay the loan.

Example

Failure to adequately assess forecast cash flow

The complainant had accepted a redundancy from an office job and decided to purchase a laundromat. She sought a loan for $300,000 to acquire (a) the goodwill of the laundromat and (b) plant and equipment, including to upgrade and then improve the purchased laundromat.

The bank approved the loan after reviewing her application, supported by:

- details of her new company and business name;
- the purchase agreement, including the vendor's disclosure of the prior four business activity statements;
- a one-page summary of how she would operate the laundromat; and
- a spreadsheet with cash flow forecasts for the next 12 months.

The bank also met with the borrower and requested:

- a guarantee from her as director, supported by a mortgage over her home; and
- a general security agreement from the company over all present and future acquired assets.

The bank file notes included a comment from the credit manager that the cash flow needed investigation, particularly the assumptions, however the loan was approved without further investigation.

The bank was a signatory to the ABA Banking Code of Practice. AFCA determined the loan was not appropriately provided with the care and skill of a diligent and prudent banker because the one-page summary and cash flow submitted by the small business lacked detail, were unsupported, and the assumptions behind the cash flow did not appear to have any basis and the cash flows were overly ambitious.

Loan appropriate based on expertise of the business owner

This example illustrates where the expertise of the business owner was reasonably relied on despite the business owner claiming at the time of her application her income was not sufficient to repay the loan and she had not worked in the industry for some time.

Example

Loan appropriate despite business owner's income

Alison obtained a business loan from a bank for $2 million to purchase a hotel from her uncle as a going concern. Alison had extensive management experience in the hotel industry, although she was only casually employed in the year before she bought the hotel. Alison lodged a complaint with AFCA claiming that the loan was inappropriate and should not have been provided to her due to her casual income.

The loan application said Alison was going to buy the hotel as a going concern and manage the business. She intended to meet loan repayments and business costs from income generated by the business. The historical financial statements provided by the vendor showed it was likely the hotel could generate sufficient income to meet its forecast commitments.

AFCA found the lender complied with its obligation under the ABA BCOP to act with the care and skill of a diligent and prudent banker when assessing the overall loan proposal.

The lender based its approval on a range of factors, including Alison's experience in the industry, the financial statements and business plan. The lender's review of historical financial statements was standard practice where a customer was proposing to buy an existing business.

AFCA assessed that Alison's employment status from the previous year did not prevent the lender from approving the loan, as the lender's overall assessment of the loan application and business prospects were sufficient to find Alison could repay the loan. The loan was appropriate.

Considering if the financial firm applied appropriate buffers

Under Australian Prudential Regulatory Authority's (APRA) prudential standards, banks are required to consider a range of criteria when assessing a borrower's repayment capacity. For small business loans, this includes consideration of repayment capacity under various scenarios, such as an increase in interest rates,

where relevant. AFCA generally considers it is appropriate for a bank to apply buffers to both new and existing variable interest rate credit products.

There may be exceptions to this approach, for example where the financial firm has documented reasons why some variable interest rate obligations are likely to be impacted differently by future interest rate changes.

AFCA recognises there may be different requirements and approaches to the use of buffers for some non-bank lenders and different credit products. When assessing whether the financial firm considered reasonably foreseeable changes in variable interest rates, we may have regard to any applicable regulatory guidance and good industry practice. We will also invite the financial firm to explain if it employed any other risk mitigant rather than applying a buffer to the rate, such as lending a lower amount.

Considering the financial firm’s policies

AFCA may consider if the financial firm complied with its own policies when conducting its credit assessment. If AFCA identifies that a financial firm breached its own policy, we will consider if this is also a breach of any lending obligations that apply to it.

When considering internal policies, we note:

- compliance with internal policies is not sufficient to find that credit was appropriately provided if the financial firm did not meet the standards in any code it subscribes to, the general law or legislation
- non-compliance with internal policies does not mean the lender has failed to comply with its obligations.

AFCA recognises a lender’s policies are primarily used to regulate its own business processes. A financial firm can exercise its commercial judgment to approve a loan that does not comply with elements of its own policy.

When a financial firm does not comply with its own policy and AFCA is considering whether the financial firm has provided an inappropriate loan, we may consider:

- if the policy allowed the financial firm to exercise commercial discretion, and if so, that it followed appropriate steps when doing so (for example, by escalating a decision for manager approval)
- the financial firm’s explanation about why the credit was approved when it did not comply with its policy.

Considering additional matters for interest only loans

Credit contracts that require interest only repayments for a period:

- will generally require principal and interest repayments at the end of the interest only period

- may require payment in full when the interest only term ends, if it is the same as the loan term.

When assessing an application for an interest only loan, we may find it was appropriate for the financial firm to consider and document how the business intends to meet future principal and interest repayments. We also recognise a small business may decide to take an interest only loan and repay the principal from the sale of the asset.

3.6 Considering if the financial firm should have asked for further information

Following our review of the financial firm's assessment process, we will consider if there were any gaps or inconsistencies in the information available to it.

If there were gaps or inconsistencies in the information, we may consider the financial firm should have made further inquiries so it could complete an appropriate credit assessment. We will assess whether the financial firm took reasonable steps to address and clarify those concerns.

Circumstances that indicate further information should have been requested

Depending on the type of loan and the obligations of the financial firm, in some circumstances a financial firm may identify that it needs to obtain further information in its credit assessment process to determine if a loan is appropriate for a small business. AFCA will consider whether the loan application involved circumstances that should have led a financial firm to make further inquiry, depending on the facts of the case.

If we identify circumstances that we assess may require further information or inquiry, and a financial firm did not make further inquiries, we may ask it to outline why it considered it appropriate to provide the loan without making further inquiries.

Considering why a financial firm did not make further inquiries

At times, a financial firm may decide not to make further inquiries despite identifying a warning sign. This may be because it considers the outcome of its inquiries would not change its decision to approve the loan.

Where financial firms do not make further inquiries, and the firm has reasons for not making those inquiries, AFCA will review its reasons to see if they provide a sufficient explanation.

We have included examples below to illustrate some common circumstances during an assessment process where a financial firm should make further inquiries to determine if the loan is appropriate for the complainant. These examples are for illustration only and are not an exhaustive list or intended to impose or imply a requirement for a financial firm to consider all or any of these factors during a credit assessment.

Example

Failure to take into account information about known future expenses

Ezra lodged a complaint with AFCA that his company was given an inappropriate loan from a bank to fund the purchase of a car wash business. Ezra worked as a teacher and had no previous business expertise. As part of his application through a business banker, he provided cash flow projections and a business plan. The financial firm approved the loan on the condition that Ezra provide a personal guarantee and secured the loan against his home.

AFCA reviewed the loan application and identified that the cash flow projections did not include salary costs for a site operator. AFCA determined the financial firm should have obtained further information about how he would fund the manager's salary, as it was aware Ezra worked full time as a teacher.

AFCA considered that the firm's failure to obtain this relevant information did not comply with their obligation under the COBA BCOP to act as a diligent and prudent banker. This was because it was reasonable for the bank to ask about how a manager's salary would be funded when it was aware Ezra worked full time elsewhere. AFCA found it was inappropriate for the financial firm to have provided the loan, as had it asked for this information, it would have determined Ezra could not afford to repay the loan.

Example

Missing information about financial history

A company applied for a small overdraft. Guarantees were required from each of its directors. In the application it disclosed one of its directors had previously been bankrupt.

The financial firm obtained financial statements about the company which showed the company could afford the loan. It did not obtain any financial records or conduct bankruptcy searches for the directors.

AFCA determined the company’s credit history was sufficient to show the loan could be repaid and it was reasonable for the firm to rely on the company financial records to provide the loan.

AFCA was satisfied that the financial firm was not required to make further inquiries about the director’s bankruptcy because the information it obtained about the company’s financial situation showed the company could repay the loan.

Example

System approved loan ought to have made more inquiries about account transactions

The complainant was the sole proprietor of a retail small business and applied online for a $30,000 overdraft to a bank who was a signatory to the ABA BCOP.

The bank’s credit assessment system considered the following and approved the loan:

- self-declared financial information from the borrower
- an ABN search of the business
- that the facility was not large
- the account conduct which showed deposits consistent with the declared income and no evidence of hardship
- that there was a surplus available for loan repayments

AFCA reviewed the account conduct which showed that a large portion of deposits were clearly not related to the business. It determined that the bank should have obtained further information about the account transactions, and had it done so, it would have assessed that the complainant could not afford to repay the loan.

Example

Sufficient enquires were made about likely income

The complainant recently commenced a carpentry business. He obtained a 4-year term goods loan from an equipment financier for a ute. The firm was not a signatory to an industry code.

The firm’s credit assessment system obtained:

- ABN and GST registration details;
- a reference from a builder who stated it intended to engage the complainant’s services; and
- the complainants credit history, which was clear.

The complainant complained to AFCA that he should not have received the goods loan as the firm did not obtain sufficient information about his future earnings.

AFCA considered the obligations owed by the firm under the ASIC Act, common law and good industry practice and determined the firm had made sufficient inquiries to appropriately assess the complaints could repay the loan based on the builder’s reference.

Example

Historical financial information is lacking for an ongoing business

An online wine merchant was a long-term customer of a lender who was a signatory to the AFIA Online Code. Its existing facilities were being satisfactorily repaid. The company applied for a short-term loan of $50,000 to assist it with a unique opportunity to purchase rare wine at auction.

As part of the loan approval process the lender asked for recent financial statements. The company said the accountant had not prepared them yet. As part of their stock, the wine was secured under the existing general security agreement.

The lender provided the loan without obtaining the recent financial statements.

The company fell into arrears and complained to AFCA that the loan should not have been provided. It said the lender should have obtained information from the accountant about its financial position. If it had, it would have seen the company revenue was declining and it was unlikely the company could meet the loan repayments.

AFCA assessed the financial firm did not comply with its obligations to assess the complainant's financial circumstances and capacity to repay. This was because the financial firm failed to ask for any information about the company's recent financial history and had it done so, it would have seen the company did not have capacity to repay the loan.

Example

Circumstances should have prompted further inquiries cash flow and business plan

FSX Pty Ltd was being pursued by a financial firm who was a signatory to the Customer Owned Banking Code of Practice to repay a loan. FSX lodged a complaint with AFCA, claiming the loan should not have been provided.

B, the sole director of FSX, approached the lender in 2022 to obtain an overdraft facility in the name of the company. He spoke with a business development manager from the bank. B provided financial statements for the business and was asked some basic questions as part of the application process, but not about the purpose of the facility.

During the application interview, B revealed he had health issues that meant he would be unable to continue lifting heavy items such as those supplied by FSX. He considered that FSX may have to hire an office manager and driver to take over his duties.

AFCA reviewed all the information available to the financial firm at the time. The historical financial statements for the business showed patchy income and that the small business could only meet its existing commitments if it stayed at its peak levels, and only then if B remained the sole employee. The business had no assets it could sell apart from an aged delivery truck, which was a required asset, and it could not support wages to any person other than B.

AFCA determined the financial firm engaged in inappropriate lending when it approved the facility as it:

- was signatory to an industry code that required it to act as a diligent and prudent banker when assessing whether FSX could repay the loan;
- failed to make further inquiries about how FSX could afford the loan when B disclosed his health conditions and patchy income statements; and
- could not reasonably have considered that FSX could meet its ongoing obligations.

3.7 Other matters that may be relevant to our decision

The type of credit may impact assessments

When assessing whether the financial firm's credit assessment was appropriate, we will have regard to the small business' circumstances and the type of credit product provided. For example, there will be different considerations for credit cards as opposed to invoice discounting and insurance premium funding products.

A financial firm's understanding of business decisions

A small business will generally be responsible for determining the needs of its business and carry the risk of its business or investment decisions. On occasion, a business may make a poor investment decision and suffer a loss.

AFCA will consider if a financial firm provided funds in circumstances where it knew or should have known because of the obligations that apply to it that the use of funds was risky or likely to cause the small business loss.

While the business is responsible for its financial decisions, we expect financial firms to sufficiently inform themselves of the intended use of funds. If a financial firm identifies the use of funds is high risk or that there is an obvious error in the financial projections, we generally expect them to make further inquiries of the small business to satisfy themselves that the loan is appropriate.

Borrowers conduct may be relevant

The conduct of the borrower may be relevant, for example in circumstances where the borrower knowingly provided falsified documents or inaccurate information. In that situation, the financial firm will usually not have breached its obligations if it could not reasonably have been aware the documents were false and it otherwise complied with its obligations.

Equally, if we find an employee of the financial firm knowingly relied on false or misleading information in the assessment, we may determine that the financial firm has breached its obligations.

4 How we determine fair outcomes and calculate loss

4.1 AFCA's Rules provide a range of remedies

AFCA’s Rules set out the remedies we may apply when determining a small business lending complaint.

AFCA may find a financial firm or small business must undertake a course of action to resolve the complaint, including:

- payment of money
- forgiveness or variation of a debt
- release of security
- repayment, waiver or variation of a fee or other amount paid to (or owing to) the financial firm, including any variation in the applicable interest rate on a loan
- reinstatement, variation, rectification, or setting aside of a contract
- meeting of a claim under an insurance policy by, for example, repairing, reinstating or replacing items of property
- when the complaint relates to a privacy breach, correcting, adding to or deleting information pertaining to the small business
- in relation to a default judgment, not enforcing the default judgment under some limited circumstances, and/or
- an apology.

AFCA’s Rule D.4 sets out the maximum amount that an AFCA decision-maker can award for direct and indirect financial loss, and non-financial loss. AFCA cannot award punitive, exemplary, or aggravated damages.

Our compensation limits include the value of any debt reductions, compensation payments or other remedies.

AFCA can award interest on compensation awards if appropriate, depending on when the loss was suffered and if the circumstances warrant an award of interest. Interest on compensation amounts is not included in the compensation limits.

4.2 General principles we apply when assessing these complaints

AFCA may determine compensation is owed for losses arising from an error or breach of obligation by a financial firm. AFCA’s focus is to compensate the small business for any loss that the financial firm’s conduct caused them. AFCA is not a regulator and therefore we do not impose fines or sanctions.

This section sets out a common approaches we apply when assessing loss. AFCA must make decisions based on what is fair in all the circumstances, rather than adopting the same approach in all scenarios.

Compensation is awarded for loss

If the financial firm fails to meet its obligations, but the small business does not suffer loss, AFCA may decide that there is no basis to award compensation. For example:

- if the financial firm has re-financed an existing loan amount with a better interest rate, we may consider the small business has not suffered a loss
- if the financial firm did not make appropriate inquiries about the small business' capacity to repay the loan, but AFCA assess that, had it made appropriate inquiries, the loan would have been appropriate.

If a financial firm charges higher interest rates or fees than the previous lender, AFCA may view this difference as forming part of a loss to the borrower. We may also award compensation for the costs a small business paid to refinance their debt.

If a small business received additional funds from a financial firm when it refinanced a debt, we may consider whether the small business is in a worse position overall. This may depend on the interest rates and fees charged by the new financial firm, compared to the previous lender, and the benefit of the additional amount.

If a financial firm's loan was at a lower interest rate, then even if the small business borrowed more funds, its total interest payments to the new financial firm may be lower. In that case, we may consider the small business has not incurred loss.

A financial firm is not liable for loss caused by business decisions

AFCA usually considers the risk associated with a business or investment decision rests with the small business, even where the credit used to fund the decision was inappropriate. If a small business incurs loss from a failed investment or business decision funded by a financial firm, we will consider what loss, if any, was caused by the financial firm providing an inappropriate credit facility.

Even if AFCA finds the financial firm did not provide an appropriate credit facility, we do not generally take into account business or investment performance when deciding a fair remedy.

Example

KCX's decision to expand its business

KCX Pty Ltd sought a loan of $950,000 from a bank, who was a signatory to the 2013 ABA BCOP, to fund its business plans which included expanding its chocolate factory and taking over a small local confectionary maker. The bank reviewed the loan application, including cash flow projections for KCX, and approved the loan.

Two years later, KCX lodged a complaint with AFCA, claiming that the loan should not have been provided as it was never affordable, that the cash flow projections were unrealistic, and the purchase of the local confectionary maker was unprofitable. KCX said that the bank should have completed more due diligence on the take-over target and on KCX's overall business plans and warned KCX not to go down the path of expansion. KCX had made $150,000 in repayments to date.

AFCA reviewed the available information and found that the cash flow figures were based on highly ambitious assumptions about sales that were untested and didn't match industry benchmarks. AFCA assessed that these circumstances indicated that KCX was not going to have access to any resources with which to repay the bank. AFCA considered the bank ought to have made further inquiries about this information during its assessment. AFCA determined if the bank had made further inquiries, it would have revealed the target confectionary maker had been making a loss for the last five years. AFCA decided the bank did not meet its obligations to act as a diligent and prudent banker when conducting its assessment and did not have any reasonable basis to approve the overall proposal.

AFCA determined it was fair in the circumstances for the bank to reimburse all interest and fees paid. KCX remained liable for the principal sum borrowed, which was the benefit it received from the loan. After deducting the payments made to date, this meant KCX had an adjusted outstanding debt of $800,000. The bank was not entitled to charge fees and interest going forward. The parties agreed KCX could repay that amount over the original term.

Although KCX also wanted the bank to be liable for the under-performance of the new addition to the company, the small confectionary maker, AFCA decided that was KCX's decision to invest in the business and that the bank was not liable for losses associated with the investment decision.

Example

ADD changes its operations

ADD Pty Ltd sought an unsecured loan for $100,000 from a bank, to assist with funding a proposal to change operations from mining to importing coffee beans from Indonesia. The bank was signatory to the 2022 COBA BCOP. In their application, ADD provided minimal information about its operations and failed to declare outstanding loans with other financial firms. ADD used the loan funds to set up a coffee bean supplier in Jakarta and to roll out a ‘brand recognition’ campaign.

A year later, ADD lodged a complaint with AFCA. It claimed the bank should not have provided the loan as it was unaffordable and that it did not conduct sufficient checks on the overall loan proposal.

AFCA reviewed the loan assessment and found that the financial firm did not exercise the care and skill of a diligent and prudent banker when assessing the loan application, as it had failed to inquire about whether the business owners had experience in the coffee industry or with importing similar goods into Australia. In fact, the directors had no experience in this regard. The firm also did not check what licences were required by the company to carry on the business, or whether it had any contracts for supply or distribution of any product.

The lender had also not conducted credit checks on the company or its directors which would have generated inquiries about other commitments. AFCA determined that if the financial firm had exercised due care and skill by making reasonable further inquiries, it would have declined the loan application.

AFCA decided it was fair in the circumstances to reimburse all interest and fees paid on the loan, but that the company remain liable for the principal (the benefit it received), subject to repayments already made. As ADD had already made $30,000 in repayments, this meant their outstanding adjusted debt was $70,000. The bank was not entitled to charge fees and interest going forward. AFCA considered ADD financial position and determined it was fair in the circumstances to require them to repay the outstanding debt over 3 years.

We may apportion loss between the parties

In some circumstances, AFCA may decide to apportion loss between the parties. We may consider apportioning loss where it is a fair outcome, for instance where the available information shows the small business contributed to the error and so

contributed to their own loss. This may occur where the borrower provided false or misleading information to the financial firm, or knowingly failed to disclose information relevant to the lending decision.

If we apportion loss, the financial firm will only have to pay a portion of the small business' loss. Any apportionment of loss will be decided based on what AFCA considers to be fair in all the circumstances.

Waiving the principal amount borrowed is generally not appropriate

Often it will not be fair to require the financial firm to waive the principal amount borrowed, because the small business has usually had the benefit of using the loan funds.

However, in some circumstances, we may determine that reducing or waiving the principal amount is fair. Examples may include where:

- the small business borrower has received no benefit or use of the loan funds (for example, due to fraud or financial abuse)
- the financial firm has engaged in unconscionable conduct
- we consider the financial firm held information which caused it to be 'on notice' that the loan funds did not benefit the small business.

Dealing with secured debts

Where AFCA finds there has been inappropriate lending and the loan is secured, we will consider if the security should be released. This will depend on what is fair in the circumstances, and the facts of each case. For example, if we determine the financial firm acted improperly or negligently in taking the security, we may consider the security should be released.

If the small business still owes a debt to the financial firm following the decision, we may consider it is fair for the security to continue until the debt is repaid. If there is no debt owed at the time of our decision, we will generally require the financial firm to release any security.

If a guarantee was provided in support of an inappropriate loan, we will generally consider the guarantee to be unenforceable.

Example

Inappropriate guarantee of business loans

Claudia was the sole director of CCC Pty Ltd. CCC refinanced its existing debt to a bank and obtained an additional overdraft and investment loan. Claudia and her husband, Peter, guaranteed the loans and provided their home as security. They had not previously had to provide guarantees in relation to CCC's obligations. CCC went into external administration. Claudia and Peter complained to AFCA and said that they should not have been approved for the credit products and that Peter should not have been a guarantor.

The bank was a signatory to the 2022 Customer Owned BCOP. AFCA found it exercised the care and skill of a diligent and prudent banker when it provided the loans. In addition, the financial firm met its obligations when it accepted Claudia's guarantee. However, the financial firm did not meet its obligations to Peter when it accepted his guarantee.

The financial firm's obligations to Peter were greater as he was not a director or shareholder of CCC and was not involved in its operations. AFCA found that Peter did not receive a prominent notice advising him that he should seek independent legal advice before signing his guarantee. In addition, the financial firm did not allow Peter any time to consider the guarantee and ancillary documentation. Instead, the financial firm insisted Peter sign the guarantee on the day Claudia provided it to him in the bank branch.

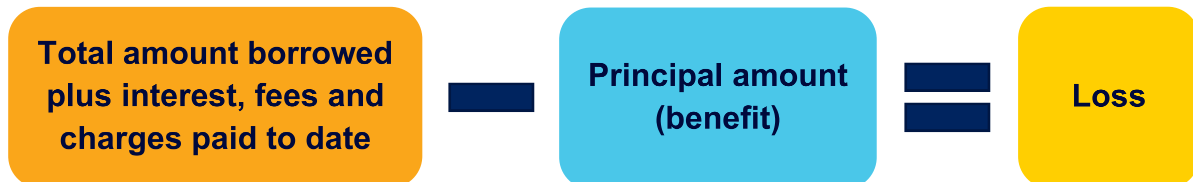
AFCA required the financial firm to immediately release Peter from all liability under his guarantee and pay him $2,000 in non-financial loss compensation for the stress it had caused.

The financial firm was allowed to recover the balance owing on the facilities from CCC and Claudia under her guarantee. The mortgage over Claudia and Peter's home was enforceable, however AFCA stipulated that the financial firm could only seek to recover repayment from Claudia's equitable interest in the property.

4.3 Calculation of compensation – general approach

How we calculate compensation

Where a financial firm provides an inappropriate loan to a small business, we require it to compensate the small business for their loss. We calculate loss by deducting the **benefit** the small business received in using the loan funds (this is usually the principal amount borrowed), from the total amount borrowed plus interest, fees and charges paid to date.



As mentioned, a small business will usually need to repay the principal amount borrowed. The lender is generally required to reimburse or waive all interest, fees and charges to the loan, being the loss caused to the small business.

Sometimes a small business will have made payments to a financial firm that total more than their benefit. In these cases, the financial firm may need to refund to the small business any amount paid that is higher than their benefit.

In some cases, where the benefit received is greater than the loss incurred, a small business may still owe money to a financial firm. We call this an **adjusted debt**.

If there is an adjusted debt owed by a small business, we will consider how it should be repaid. A financial firm will not generally be able to charge interest or fees on the adjusted debt going forward. The next section of this Approach provides more information.

There may be limited circumstances where AFCA decides a portion of the debt should be waived based on fairness.

We may apply a different approach when assessing loss caused by inappropriate commercial leases, which is set out below in section 4.4.

AFCA applies a flexible approach to repayment of an adjusted debt

Where the small business owes an adjusted debt to the financial firm, we apply a flexible approach when determining how the debt should be repaid.

This may include:

- reducing or varying the interest rate payable on any adjusted debt balance
- varying or extending the term of the loan contract

- varying the loan contract to assist the small business in a period of financial hardship such as a repayment moratorium
- requiring a financial firm to refrain from enforcing any security for a period of time, ceasing to charge interest or charging a lower rate of interest
- allowing time to sell a security asset, source funds or refinance to another financial firm.

Example

Albert's Plumbing

Albert's Plumbing had been operating for seven years. It obtained a $400,000 loan to purchase two new vans and cover short term cash-flow needs. The loan was secured by company assets including the two new vans, and a personal guarantee by Albert.

Upon reviewing the information AFCA determined that the financial firm did not lend appropriately.

AFCA decided the financial firm should reimburse all interest and fees incurred on the account. In addition, AFCA determined that any personal guarantees provided to secure the loan could not be relied on by the bank. Albert's Plumbing was required to repay the principal sum borrowed, as it had received a benefit from these funds. Taking into account repayments made to date, this left an adjusted outstanding debt of $360,000.

When assessing how the adjusted debt should be repaid, AFCA considered the current financial position of Albert's Plumbing which included a number of assets it could sell to trade out of difficulty. AFCA provided the borrower with 12 months to repay the adjusted debt, during which time no further interest or fees were chargeable on the loan.

4.4 Calculating loss for commercial leases

Nature of commercial leases

A small business may lease an asset, rather than borrow to buy that asset. The leased asset remains the property of the lessor. The small business pays rental payments instead of loan repayments. There is technically no interest charged under a commercial lease.

A lessee does not have an automatic right to own the assets at the end of the lease. Instead, it will generally have the following options:

- hand the goods back to the lessor, in which case the lessor may sell the goods at auction at the lessee's cost. The value will be deducted from any amounts owing under the lease such as the residual value;
- ask to purchase the goods; or
- apply to the lessor to extend the lease.

Calculating loss for commercial leases

Where a financial firm provided an inappropriate commercial lease, we generally require them to compensate the small business for their loss.

Where we find the commercial lease was inappropriately provided, we may require the asset to be returned to the lessor, at their cost, within a defined period.

We calculate the loss caused to a small business from an inappropriate lease by:

- calculating the total repayments made up to the return date (A);
- calculating the portion of the total repayments that represents a fair value for the use of the asset to date (this is the benefit the small business received from the lease) (B); and
- calculate the difference between repayments and the benefit (A – B).

If A – B is greater than 0 (repayments are more than the benefit of use), the lessor must pay the difference to the small business lessee. If A – B is less than 0 (repayments are less than the benefit of use), the lessee must pay the difference to the lessor.

This approach results in the lessee having use of the asset and paying only to the return date, and the lessor regaining access to its asset on that date. Usually, AFCA considers it fair for the lessor to absorb the risk of the sale price being less than the amount owed by the lessee after the asset is returned.

If there is an amount owed by the lessee, we will consider how this amount should be repaid. Information about our approach to repayment of any amount owing is set out above.

We will consider the circumstances of the parties when providing an appropriate remedy. These can include:

- the contractual relationship between the lessor and the asset supplier
- whether the lessor or its agents misled the small business or acted unconscionably when the lease agreement was entered into

- whether the asset purchase price was artificially inflated through, for example, transfer pricing between related parties
- where the asset is damaged on return to the lessor.

If the lessee has made payments greater than the value of the goods or has paid part of the value of the goods and has capacity to pay the remaining amount in a reasonable time, we may allow the lessee to retain the goods. We generally require any guarantee to be released where the lease has been found to be inappropriate.

Example

Calculating loss for an inappropriate commercial lease

BetaLife Pty Ltd obtained a lease for a company car from a financial firm. The company director lodged a complaint with AFCA when he realised after a few months that the company could no longer afford the lease payments of $1,000 per month. The Director said the financial firm should never have provided the lease to the BetaLife.

AFCA assessed that based on the information available, the financial firm should reasonably have known BetaLife could not afford the monthly lease payments and therefore should not have provided the lease.

As the lease should not have been provided, AFCA considered the loss this caused BetaLife.

At the time of the complaint BetaLife had paid $5800 ($800 application fee, and $5000 in rental payments).

AFCA assessed a fair amount for the benefit of the use BetaLife had received from the car to date was $4,800.

Total payments made		Fair amount for benefit of use*		Loss
	MINUS		EQUALS	
$5,800		$4,800		$1000

As the fees and payments amounted to $1,000 more than the cost of goods to date, the financial firm was required to refund the company $1,000 to BetaLife upon surrender of the vehicle.

The financial firm was also required to waive all future lease payments owing under the contract and release the small business from its contractual obligations.

**in this case, AFCA calculated the fair amount for benefit of use using a straight line depreciation from the cost price to the residual value of the car for the duration of the commercial lease.*

4.5 Calculating loss for misleading conduct

A financial firm is prohibited from engaging in misleading conduct or conduct that is likely to mislead or deceive.

The remedy for misleading conduct is not to make the promise (misrepresentation) come true, but to ask if the small business has suffered any loss as a result. Accordingly, AFCA's usual remedy where we find there has been misleading conduct is to assess the small business's loss as a result of relying on it.

When considering a complaint relating to misleading conduct, AFCA will have regard to the factors outlined in the AFCA Approach to misleading conduct.

Example

Misrepresentation about loan terms

A small business had six separate loans, secured by mortgages on six commercial properties. Each loan had been refinanced at different times, which made it difficult for the business to keep track of the terms of the loans and their expiry dates. The loans were all subject to different interest-only repayment periods.

In June 2018, the small business emailed the financial firm and asked when the interest-only period on Loan 1 would expire. The financial firm told the business it was due to expire soon, in December 2019. However, under the contract, the interest-only period for Loan 1 was due to expire in 2025. In October 2018 in reliance on the financial firm's representation, the small business elected to vary Loan 1 to principal and interest payments.

After reviewing the original loan documents, the business realised the financial firm had told them incorrect information and lodged a complaint with AFCA. The business asked AFCA to change the loan back to an interest only term and refund all payments it had made towards the principal since October 2018.

AFCA found the business had relied on the misleading information from the financial firm which caused it to elect to vary the loan contract.

AFCA determined it was fair in the circumstances that the loan be changed back to interest-only until 2025. This was because the business had only changed the loan to principal and interest repayments in October 2018 by relying on misleading information from the financial firm. However, AFCA did not refund to the business the principal payments made from October 2018, as the business had not established it was any worse off as a result of making those payments. Rather, the principal payments had reduced the business's interest repayment liability.

4.6 Indirect financial loss and non-financial loss

AFCA's Rules enable it to provide a limited amount of compensation for non-financial loss arising from an error or breach of obligation by a financial firm. The compensation limits are set out in our Rules.

Non-financial loss may be awarded where a person has incurred an unusual degree or extent of physical inconvenience, time taken to resolve a situation or interference with the expectation of enjoyment or peace of mind, arising as a result of an error or breach of obligation by the financial firm.

When determining the appropriate amount of non-financial loss to award, AFCA will consider the factors outlined in the AFCA Approach to non-financial loss claims.

Indirect loss is financial loss which is caused by a financial firm's conduct but is more distant than direct financial loss. Examples include loss of profit or revenue or additional amounts payable to a third party.

Before we decide whether to award compensation for indirect loss, we will consider:

- if a financial firm made an error or failed to comply with an obligation to a small business;
- if so, what loss the small business suffered because of the financial firm's actions
- if the loss was reasonably foreseeable to both parties; and
- whether the loss is too remote from the error or failure.

A small business will generally need to provide information that shows the loss and how it was caused. For example, when claiming for loss of profit, a small business will need to provide records showing the profit it usually made, but did not make, because of a financial firm's error.

5 Other issues

5.1 Joinder

Under AFCA's Rules, we may decide at any time that it is appropriate to join another financial firm as a party to an existing complaint. A joined financial firm has the same rights and obligations during the complaint process as if it were the original financial firm. Information about the joinder process is contained in AFCA's Operational Guidelines.

In appropriate lending complaints, AFCA may consider joining a financial firm where the original complaint is lodged against a broker, but it is possible the credit provider may have contributed to the loss claimed. Likewise, a broker may be joined to a complaint against a credit provider.

If AFCA decides that compensation is payable to a small business, we will allocate liability between the financial firms in a manner that is fair in the circumstances of the complaint.

6 References

Definitions

Term	Definition
Complainant	An individual or small business that has lodged a complaint with AFCA
Financial firm	An organisation or individual that is a member of AFCA

Useful documents

Document type	Title
Rules	AFCA's Rules | Australian Financial Complaints Authority (AFCA)
Operational Guidelines	AFCA's Operational Guidelines | Australian Financial Complaints Authority (AFCA)
Act	*Australian Securities and Investments Commission Act 2001* (Cth)
Act	*National Consumer Credit Protection Act 2009* (Cth)
Code of Practice	Australian Banking Association's Banking Code of Practice
Code of Practice	Customer Owned Banking Code of Practice
Code of Practice	Australian Finance Industry Association's Online Small Business Lenders Code of Practice
Code of Practice	Australian Finance Industry Association's Insurance Premium Funding Code of Practice

7 Case study

ABC Pty Ltd obtained a $200,000 loan from a bank to purchase a new business. The loan term was two years with interest-only repayments over the full term of the loan. The loan was secured by ABC's commercial property and a guarantee and indemnity was provided by ABC's director.

As part of its assessment, the bank included certain loan covenants in the loan contract including the provision by ABC of quarterly accountant-prepared financial statements.

Leading up to the expiry of the loan's term, the director applied to renew the loan for a further interest-only term of 12 months. The bank completed a credit assessment and approved a further 12-month term. Over the next few years and upon request from the director, the bank approved a further three 12-month interest-only extensions to the loan. The bank sent variation letters for each of the extensions outlining the new term and expiry date.

ABC then experienced a reduction in sales and a tightening in its cashflow. In the month prior to the most recent loan expiry, the director requested a further loan term extension. The bank required additional financial information due to the deterioration in ABC's performance.

The ABC's director objected to the request for additional financial information as he said it was unreasonable. The director also disputed the expiry date of the loan, claiming he thought the initial loan term was 10 years. He said the loan term extensions approved to date were only 'annual reviews' completed within the original 10-year loan term the bank was obligated to renew the loan for a further four years.

AFCA reviewed the available information including the original loan contract, variation letters and all file notes. AFCA found the request for additional financial information and the decision whether to extend the loan for a further term were not unreasonable but were credit risk assessment decisions. Under its Rules, AFCA cannot generally consider credit risk assessment decisions made by a financial firm. AFCA also found that the initial loan term was two years and that the bank had approved four term extensions, each being 12 months. AFCA found the loan would expire at the end of the current 12-month term.