



Law Council  
OF AUSTRALIA

*Business Law Section*

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The Treasury  
Langton Crescent  
PARKES ACT 2600  
Via email: [creditphase2bill@treasury.gov.au](mailto:creditphase2bill@treasury.gov.au)

1 March 2013

Dear Sir or Madam,

## **National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012**

### **1. Introduction**

- 1.1 The Financial Services Committee of the Business Law Section of the Law Council of Australia (**Committee**) is pleased to provide this submission in response to the consultation process operated by The Treasury of the Commonwealth (**Treasury**) into the National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012 (**Bill**) and related proposed draft regulations.
- 1.2 The Committee notes the email from Christian Mikula of 18 February 2013, announcing that the Government has decided to defer the small business finance reform proposals contained in Schedule 2 of the Bill on the basis that the Bill's release "*has raised consideration of whether the benefits could be delivered in a more targeted and effective way, through the development of a different model from that in the Phase 2 Bill*".
- 1.3 Although the Committee understands that Treasury no longer proposes to consult formally on the model set out in Schedule 2 at this time, the Committee attaches comments in Attachment A which had already been prepared in the hope that they will support the consideration of a more

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targeted and effective model. The Committee had significant concerns about aspects of the approach taken by Schedule 2.

- 1.4 The Committee may wish to provide further comment if there is an opportunity to do so at any subsequent stages of this inquiry. Please contact the Chair of the Committee, James Moore, [jmoore@hwle.com.au](mailto:jmoore@hwle.com.au), +61 2 9334 868 if you wish to discuss further any matter contained in it.

Yours faithfully,



Frank O'Loughlin  
**Section Chairman**

# Submission

## 1. Overview

1.1 The Financial Services Committee of the Business Law Section of the Law Council of Australia (**Committee**) seeks to approach regulatory change proposals with a focus on evidence based regulation and on regulatory proposals that are measured and proportionate to the aims sought to be achieved.

1.2 The Committee has a number of key concerns about the Bill as set out in more detail in the table below which responds to questions raised in the consultation package. They are summarised below.

### (a) **Anti-avoidance provision**

The Committee submits that the proposed anti-avoidance mechanism is based on an unsuitable precedent and premise, and should be entirely reconsidered. In short, precedents of the kind found in taxation legislation are unsuitable, as there is no implicit obligation for businesses to provide regulated credit. As drafted it would impose criminal offences on an extremely wide range of Australian businesses that have no substantial credit activity. Such businesses legitimately choose to conduct their business in such a way as to avoid providing Code regulated credit, such as by invoicing on 61 day terms or refraining from charging interest. The provision as drafted would also apparently criminalise businesses legitimately relying on express licensing exemptions. The Committee submits that one option to resolve this material issue would be to redraft so that the question of whether a "scheme" exists to change the application of the NCCP Act should not arise unless the conduct of the business (including that of any associates) has an in-substance purpose or effect of obtaining the economic benefits usually enjoyed by a lender in a manner that would not be exempt from regulation.

### (b) **Unintended impact on mortgages and guarantees**

As the proposed investment lending amendments operate by expanding the definition of "credit" in the National Credit Code (**Code**) for the purpose of imposing responsible lending obligations under the National Consumer Credit Protection Act (**NCCP Act**), they unintentionally extend the meaning of "mortgage" and "guarantee" to cover mortgages and guarantees given in relation to an investment credit contract, and extend the operation of the Code in relation to such mortgages and guarantees. The provisions should be amended so as to not have this effect.

### (c) **Investment lending divorced from small business lending**

The Committee notes with concern that the investment lending provisions in Schedule 3 follow substantially the same model as the Schedule 2 amendments which have been determined to have a risk of not being well targeted or effective. Further, if the Schedule 3 investment reforms are proceeded with in the absence of the Schedule 2 small business reforms, the Committee suggests that ambiguity might be raised whether a loan to an individual for the purposes of a small business may be construed as investment related, having regard to the exceptionally broad language proposed for the amended section 5(1)(b) of the NCC. This would defeat the policy decision that small business activity not be regulated under the proposed model. At the very least, it would be appropriate to include an exhaustive definition of "investment purpose" so that it will be clear that section 5(1)(b) is not intended to cover all lending (to individuals or strata corporations) of any kind whatsoever. In the view of the Committee, it is not possible to discern such an intention from the current drafting.

(d) **Investment lending - coverage**

Investment credit contracts are proposed to be differentially regulated on the basis of whether the relevant investment is a *Corporations Act 2001* (**Corporations Act**) "financial product" and is being offered in accordance with the Corporations Act. Firstly, the Committee submits that the intended benefit of this provision - that it is usually easy to determine whether a person has an Australian financial services licence (**AFS licence**) - may not be a real benefit in practice as there are a variety of ways in which financial products may be dealt with that do not involve a licensee. More significantly, the Committee believes that applying:

- (i) a higher responsible lending threshold to a broad sweep of investments (not being financial products offered in accordance with the Corporations Act), and
- (ii) minimal responsible lending requirements for Corporations Act financial products provided in accordance with the Corporations Act, only in circumstances where there will be a residential mortgage,

ignores the material difference in risks and returns that may exist for such products and risks causing artificial changes to the market price of investment products generally.

(e) **Investment lending - "gatekeeper" risk**

The Committee notes that one of the controversies regarding the regulation of investment lending is a desire by financiers not to be seen as "gatekeepers" whose role is to decide which investments consumers are permitted to make and which investments are to be forbidden. Further, as the financier will usually not share in any "upside" where an investment is successful, it may be unreasonable to expose financiers to any financial "downside" where an investment is unsuccessful. The Committee submits that it would be appropriate to provide for statutory assumptions that a financier is entitled to make in relation to the return of proposed investments over the term of a relevant loan (such as that investments can be assumed without investigation to have a compound return of 5% per annum with no capital risk), even if those returns are not in fact realised.

(f) **Investment lending - scalability**

The Committee submits that it would be helpful, given the extremely broad range of investment credit contracts that will potentially be subject to unsuitability assessments, to include specific provisions clarifying that in some cases it may be reasonable to take no steps to verify a matter, clarifying some practical uncertainty that exists about the concept of "scalability" in the existing responsible lending regime.

(g) **Sophisticated investor relief**

Just as the major consumer protection provisions under Chapter 7 of the Corporations Act (such as mandatory membership of an external dispute resolution scheme, Product Disclosure Statements and financial services guides) are not required to be provided to a person who qualifies as a "wholesale client", the Committee believes it would be appropriate to include sophisticated investor relief under which the proposed Schedule 3 reforms would not apply. As with the Corporations Act, there could be an onus on the service provider to satisfy itself that the client was truly a sophisticated investor.

(h) **Consumer leases - "requisite belief"**

The Committee submits that the provisions regarding a "requisite belief" as to the length of time that a proposed lessee wishes to lease goods should allow a lessor to rely on the stated intentions of the lessee without further investigation, unless a relevant person actually knows that the stated intentions are incorrect.

(i) **Disproportionate penalties**

While the proposed penalties are consistent with the current penalties for non-compliance with the NCCP Act, the Committee submits that these penalties are entirely disproportionate to the harm caused by breach, and more appropriate penalties should be specified in the Bill, with more appropriate penalties under the NCCP Act determined at a later stage. In any event, the setting of maximum penalties for such offences at the level of (for example) "2,000 penalty units" was essentially determined in 2009 and should be reviewed having regard to the recent 55% increase in the value of a penalty unit.

**2. Response to questions raised in consultation draft**

**Enactment Provisions**

Section 2 –  
Commencement  
provision

Length of the transitional period to be provided for each Schedule of the Bill.

Industry groups may be able to provide more specific comment, however many of the proposals will require material change to systems and procedures, and require assessment of whether current business models remain viable. A period of less than 12 months is unlikely to be suitable. The 6 month period proposed is unlikely to be adequate to allow for significant system development and the development of disclosure documents.

Further, the Committee notes that the relevant transition period required by business needs to commence from the date that the final relevant regulations have been made and finalised, rather than from an earlier time when the legislation may have passed the Parliament.

**Schedule 2 - Small business lending**

We note that these provisions have been removed from the consultation but provide comments in Attachment A in the hope that these will assist Treasury in its aim of preparing a form of regulation that operates in a "more targeted and effective way". The Committee has significant concerns about the overall design and the substance of Schedule 2.

**Schedule 3 – Investment Lending**

Item 2, subsections  
5(3) and (4)

Applying licensing obligations under Chapter 2 of the *National Consumer Credit Protection Act 2009* to credit contracts that will be regulated as a result of the predominant use of the credit being for investment purposes.

The Committee expresses no view on the proposal that the NCCP Act Chapter 2 licensing provisions are to apply to lending for investment purposes.

The existing exemptions and modifications under Part 2-4 of the Regulations have of course been developed in the context of consumer credit regulation as previously implemented under the Consumer Credit Code, and the Committee encourages Treasury to engage with entities involved in investment lending who may have need for appropriate exemptions from the proposed regulation.

The Committee has not investigated whether the current investment lending sector includes less sophisticated businesses that have not

	<p>previously been required to comply with the NCCP Act but notes that if there are any such businesses they may find it difficult to develop systems and processes to deal with the highly technical requirements of the NCCP Act.</p> <p>An appropriate transition period should be allowed under which such entities may register and develop systems to seek a licence or appointment as a credit representative if they decide to continue operations.</p>
<p>Item 3, paragraphs 13(2)(a), (b), (c) and (d).</p>	<p>Whether there are any classes of consumer leases for investment purposes that should be regulated.</p>
	<p>The Committee has no knowledge either way.</p>
<p>Items 12 and 13, sections 112A and 125A</p>	<p>Explanation that responsible lending obligations do not apply to investment credit contracts generally, but only to two classes of such contracts (known collectively as protected investment credit contracts).</p> <p>These classes of contracts are:</p> <ul style="list-style-type: none"> <li>• regulated product (home-secured) investment contracts; and</li> <li>• unregulated product investment credit contracts.</li> </ul>
	<p>The Committee observes that while this comment refers to "only two" classes of regulated contract, one of those classes is a "catch all" that encompasses loans in relation to <b>all</b> investments of any kind not being financial products, and most categories of loans relating to financial products.</p>
<p>Item 18, Part 3-2E, section 133EB</p>	<p>Definitions of regulated product (home-secured) investment contracts and unregulated product investment credit contracts, and further refining the latter category of contracts to address conduct where the payment of commissions or other financial arrangements creates a risk of conflicted advice.</p>
	<p><b>Does the Corporations Act distinction focus on the relevant risks?</b></p> <p>While the Committee in principle welcomes a regime that allows ready distinctions to be drawn (the essential factor is whether the investment product is a Corporations Act financial product, offered in accordance with the Corporations Act, or not), the Committee queries whether the existence or otherwise of an AFS licence or a relevant Corporations Act exemption is such an accurate predictor of the risk of investment products that it should be given such importance.</p> <p>It appears that this distinction may have been selected on the basis that it is straightforward to determine whether a given person holds an AFS licence. The Committee notes however that a wide range of financial product dealings may be possible without an AFS licence (such as dealing in securities on the seller's own behalf, or offering financial products under an intermediary authorisation referred to in Corporations Act section 911A(2)(b)), and that there will not usually be any simple test to determine whether a particular financial product is being distributed lawfully. Accordingly, the justification for making the distinction in this way may not be substantial.</p> <p>Recent history of losses by investors has shown that financial products</p>

distributed in accordance with the Corporations Act can lead to consumer losses. Equally, a wide range of alternative investments exist with a wide range of risk profiles. For example, direct investment in physically settled gold bullion has an inherently different risk profile than investment in a motion picture, but may have a similar profile to directly investing in securities of a gold mining company (under a loan that is not a Corporations Act margin loan).

Further, the Committee suggests that there must be room for doubt as to why it is appropriate that loans to acquire financial products require responsible lending measures only where the loan is to be secured by a residential mortgage but for all other investment purpose loans a higher degree of responsible lending is to be required whether or not security over residential property is to be taken. Applying a uniformly high standard to all such products may distort the market for investment products, artificially increasing the price of financial products and depressing the price of others.

The Committee would welcome Treasury releasing any detailed evidence as to why this is considered to be the appropriate and proportionate distinction to draw.

#### **Potential unintended coverage of small business**

Further, if Schedule 3 is introduced in its current form, the Committee submits that it may cause significant ambiguity, as there may be doubt as to whether a loan in relation to a small business might be regarded as a form of investment. To the extent that the currently proposed section 133EB can be said to be clear, it is only in that it appears to evince an intention to cover absolutely all lending of any kind to an individual or strata corporation as NCC regulated "credit" (on the basis that it were implemented at the same time as regulation under the Code of small business credit).

The combination of choosing not to include a specific definition of "investment", and of the decision to defer small business credit regulation until a more targeted and effective regime can be developed, will (in the submission of the Committee) bring great ambiguity to provisions that are currently well understood. In the absence of this specific definition, it is possible that many loans in relation to a small business would (under Schedule 3) be treated as "protected investment credit contracts" and be subjected to a higher standard of regulation than would have applied under the now withdrawn Schedule 2.

At the very least, specific and comprehensive definitions of "investment" should be included which clearly exclude small business activities of a kind that the Government has decided should not be regulated at this time, under this model.

At a broader level, the Committee notes that there has been a determination by the Government that the Schedule 2 amendments may not be targeted and effective, that a different model should be chosen, and that there is a risk that the small business reforms would not be 'got right' under the model in Schedule 2. The Committee notes that Schedule 3 proceeds along precisely the same model as Schedule 2, and may share many of the risks of unintended and adverse consequences that would have flowed from Schedule 2 being implemented. The Committee submits that the same reasons that the Government has determined not to proceed with business reform at this time could apply with equal force to the Schedule 3 proposals in relation to investment lending.

**Professional investor**

Finally, the Committee considers that there would be strong policy and efficiency grounds to provide for some form of "professional; investor" relief modelled on Chapter 7 of the Corporations Act so that (for example) commercial lenders to very high net worth individuals would not be required to hold a "retail" credit licence.

Item 18, Division 2

Explanation of the responsible lending obligations introduced in Division 2, in relation to protected investment credit contracts, follow the existing model in the Credit Act.

Item 18, Division 2,  
Subdivision A, section  
133EC

Requirement for a provider of credit assistance to provide a quote, in relation to protected investment credit contracts.

**Whether credit provider must give quote**

The Committee submits that an analogue of section 112 should be included so that these quote provisions will not apply to the credit provider, for the same reasons that credit providers are not required to provide a quote before accepting and considering an application.

**Breadth of "credit assistance"**

The Committee submits that the trigger event for quotes to be provided should be reconsidered. Experience has shown that it can be very difficult in practice and in a systematic way to distinguish casual referrals or incidental provision of help from being "credit assistance". Obligations should not apply until the relevant activity is systemic and substantially directed towards the provision of the relevant loan or limit increase.

**Penalties disproportionate**

In the Committee's view, the proposed penalties for failing to comply with the requirements of section 133EC are likely to be wholly disproportionate to the mischief that is proposed to be managed and they should be revised.

**Application to intermediaries**

We note that in the equivalent sections of Schedule 2, a specific question was raised on whether the quote obligation should apply to intermediaries. The Committee strongly believes that it would be inappropriate to apply the section to intermediaries. It is in the nature of intermediaries that they do not deal directly with the consumer. A quote mechanism would require a direct connection between the consumer and the intermediary that would not otherwise exist and introduce complexity and delay into application processes for questionable benefits. Any charges relating to the intermediary's services could only be imposed by entities dealing with the consumer and controls already exist on a provider of credit assistance and on the credit provider.

**Where no charge**

The Committee submits that there should be no obligation to provide a quote where the relevant credit assistance provider will not charge a fee for the relevant assistance.

**Partial payment up-front**

In an investment context, the Committee queries whether it is appropriate to ban any payment being provided or demanded before the credit assistance process is complete. At least a part payment on account of arms length third party expenses might be reasonably obtained before the services are provided.

Item 18, Division 2,  
Subdivision B

Inquiries that a provider of credit assistance would be required to make, to ensure that a protected investment credit contract is suitable, including, where the contract is secured by a mortgage over their home, that the borrower appreciates the consequent risks.

Further to the comment regarding section 133EB above, while the Committee believes that streamlined processes should be preferred, the mere fact that an investment is a financial product offered in accordance with the Corporations Act does not seem an appropriate justification for not requiring any enquiries as to or verification of financial position.

The Committee notes that since the commencement of the NCCP Act there has been considerable uncertainty and commercial disagreement as to what amounts to reasonable enquiries and reasonable verification of financial position and the interpretation of the concept of "scalability".

The Committee notes that a key policy concern in relation to the regulation of investment lending is that lenders (who seek a predictable return on the amounts lent and are generally not exposed to the downside or upside of investment decisions by consumers) should not be expressly or implicitly required to review or "second guess" a consumer's decision in relation to investment products.

To manage this concern it would be appropriate to include a specific provision acknowledging that the credit assistance provider and credit provider are not required to consider the merits or prospects of the proposed investment, merely the consumer's stated willingness (or not) to risk their residence and (as applicable) the customer's current financial position and prospects, excluding the proposed investment.

The Committee submits that for the purpose of unsuitability assessments, it may be appropriate to allow credit providers to assume (regardless of any investigation) that each investment will be capital protected and will provide a compound return of (for example) 5% per annum, and are not put on enquiry (except perhaps where they are an associate of the promoter).

Item 18, Division 3

Explanation of the responsible lending obligations introduced in Division 3, in relation to protected investment credit contracts, follow the existing model in the Credit Act.

Noted.

In the submission of the Committee, Divisions 2 and 3 should more closely follow the existing model in the NCCP Act by expressly excluding Division 2 from applying to a person who is or will be the credit provider.

Item 18, Division 3,  
section 133EK

Inquiries that a credit provider would be required to make, to ensure that a protected investment credit contract is suitable, including, where the contract is secured by a mortgage over their home, that the borrower appreciates the consequent risks.

Given that, for unregulated product investment credit contracts, enquiries and verification of financial position are required whether or not the consumer's residence (or any other property) is to be security for the proposed credit contract, the Committee submits that it would be important that the legislation expressly acknowledge that the scope of enquiries that must be made will vary considerably in proportion with the scale of the investment and the Borrower's financial capabilities. It would be helpful for the legislation to expressly acknowledge that in many cases (perhaps giving non-exclusive examples) no specific steps need be taken to verify matters.

For example, it could be specified that there would be no need to take any step beyond obtaining a credit report from a credit reporting body, where the amount of the credit is relatively small (for example \$5,000 or less) in comparison with the investor's stated income and assets, and the information available to the lender is internally consistent.

Item 19, section 179

Explanation of the operation of a presumption that a court should make an order enabling a consumer to remain in their place of residence where the credit provider is knowingly involved in a contravention of section 911A or section 911B of the Corporations Act (that is, the requirement to hold an Australian financial services licence).

Noted

Item 22, section 203C

Explanation of the operation of the provision that applies the unjust contract provisions in the National Credit Code to investment credit contracts, but otherwise excludes the substantive provisions in the Code from applying to these contracts.

**Key concern - Inadequacy of definitions - "credit contract" - impact on guarantees and mortgages** The Committee notes with concern that the proposed amendments in effect make the Code apply to virtually all credit contracts with an individual (perhaps with the exception of a contract in relation to a small business that is not an "investment", subject to whatever future regulation (if any) may be made).

Under the section 5 definition, it follows that all such contracts will become "credit contracts", as at least part of the Code applies to them.

This would in the Committee's view have the adverse and unintended consequence that all guarantees and mortgages related to such contracts will be "guarantees" and "mortgages" regulated by the Code. Despite investment credit contracts having an exemption from the majority of the Code, it is not clear to what extent provisions of the Code would apply to guarantees and mortgages in relation to such exempt contracts. For example, sections 41 and 54 of the Code may not be regarded as implicitly excluding the application of Part 3 from a mortgage or guarantee in relation to an investment credit contract. Section 62 (for example) appears on its face to apply generally to "guarantees" as defined in section 8) independently of section 54.

To avoid this result, it would be necessary to amend section 5 so that "credit contracts" expressly excluded the 3 species of defined investment credit contracts. We have not been able to form an assessment of whether making that change could have some effect on the intended policy.

An alternative approach would be to amend the proposed section 203C so that it also excluded mortgages and guarantees (and related matters) from the provisions of the Code mentioned there, to the extent that they relate to investment credit contracts but not otherwise.

## Schedule 4 – Private lending

Items 1, 2 and 3,  
sections 5 and 170

Explanation of how the definition of regulated credit contracts is to be expanded to include contracts where:

- the credit provider or lessor is a private individual who is not in the business of providing credit or consumer leases; and
- the contract is arranged by an intermediary.

The commentary also discusses the circumstances in which such persons are excluded from the requirement to hold an Australian credit licence (as set out in the regulations).

The Committee notes the proposed amendments and notes that for the purposes of the NCCP Act and responsible lending requirements, private loans arranged through an intermediary are to be treated in a similar way to a servicer with a credit licence under a securitisation or similar arrangement.

The Committee notes that a number of the more significant peer to peer lending "arrangers" currently targeting Australian borrowers and moving into the Australian market - are large British and American companies with a limited physical presence in Australia (some only have an online presence), and very few (if any) private lenders within their "pools" who reside within Australia.

Given this, the Committee queries whether it is practically feasible for each private lender to be personally a member of an external dispute resolution (**EDR**) scheme, to be effectively bound by the rules of an EDR scheme, and for the EDR schemes to enforce rulings upon private lenders (particularly if those lenders reside overseas).

The Committee suggests that Treasury's policy objective could be satisfied through alternative means, if the loan arranger's servicing agreement (with the private lender) was required to include a provision which delegated to the arranger the authority to be a member of an EDR scheme on behalf of the private lender (and its own behalf) and bound the private lender to follow the outcome of EDR processes.

Further, the Committee notes that the proposed regime does not specify how Code disclosure requirements and compliance are intended to be managed for private loans. In the Committee's view, it would be possible to take further steps to provide a clearer national framework for peer-to-peer lending, such as by providing mechanisms under the Code for the licensed intermediary to act as proxy for a private lender or lenders (and as between the Consumer and the licensed intermediary, being liable for the consequences of any non-compliance).

The Committee notes that it is possible, given the current construction of the proposed amendments, for private lenders and intermediaries to escape regulation. Some existing overseas peer-to-peer lending providers provide a "mere" and "for fee/commission" matching service. These matching services operate in a similar way to internet dating

services, with a number of "matches" returned for each search (which can be run by either a borrower or a private lender). All subsequent selections and 'arrangements' are dealt with solely and directly between the credit provider and debtor. The Committee questions whether such arrangements would be regulated by the proposed regime, and notes that should they be unregulated – a market distortion will result that could disadvantage both regulated peer to peer lenders and regulated small amount credit contract lenders.

## Schedule 5 – Consumer leases

Item 2, section 170A

Approach taken to regulating short-term leases and indefinite term leases that are currently exempt under subsection 171(2), by requiring lessors to make reasonable inquiries into the lessee's intended period of use.

The new defined term "requisite belief" is intended for use in determining the intended period of use by a proposed lessor of equipment to be provided under a consumer lease.

As this will be a matter uniquely known to the proposed lessee consumer, the Committee strongly recommends that the section 204(1) requisite belief test should be expressly limited to (but include) the lessor expressly asking the consumer about their approximate intended period of use. The legislation should include an express provision stating that the lessor need not seek to independently verify or to second-guess the information provided by the consumer, unless the consumer has specifically provided inconsistent information about its intention to the lessor or a relevant person and has not subsequently changed their mind.

Item 10, subsection 204(1)

Explanation of how the definition of 'requisite belief', relevant to the inquiries to be made into the lessee's intended period of use, is based on the wording in section 13 of the National Credit Code.

See comment above.

## Schedule 6 – Anti-avoidance

Item 5, section 323A

Adopting a systematic response to avoidance practices, rather than individual responses being developed as a particular practice emerges.

The Committee supports proportionate and measured legislative reform to deal with techniques that may be in the nature of credit but on a technicality fail to be regulated by the NCCP Act.

However, the Committee does not believe that the proposed anti-avoidance test is appropriate in relation to credit regulation.

Anti-avoidance provisions are commonly found in revenue statutes, and there is a general requirement that organisations and persons conduct themselves so as to pay tax.

The model that has been chosen is on the Committee's submission entirely inappropriate for the reason that there is no general expectation that people or organisations will provide regulated credit. People are free (and the great majority of businesses choose) not to provide regulated

credit, but they could readily inadvertently fall into doing so by small changes to how they carry on business.

The anti-avoidance provision on its face would impose a pecuniary penalty of up to \$1.7 million (on a civil standard of proof) and up to 2 years imprisonment on a person who engages in non-credit activities but who could engage in credit activities by behaving differently.

This is in our submission highly inappropriate, as a wide range of organisations may (and should be able to) legitimately choose to not engage in activities that would require them to hold a credit licence, and equally may legitimately choose to conduct their activities on a basis that qualifies for an exemption.

As a simple example, a utility provider could hypothetically state that no action would be taken to disconnect a customer until invoices are outstanding by 90 days or more, but that interest charges at 5% per annum will be applied to invoiced amounts after the 30th day outstanding. *Such a model would not qualify for the "short term" credit exemption under section 6(1) of the Code, and would be regulated credit, and licensing and disclosure obligations under the NCCP Act and Code would apply.*

How then does the proposed anti-avoidance provision apply to utility providers who instead choose to require payment within 61 days (thus qualifying for the short term exemption)? There is no basis in the proposed section 323A as drafted to conclude that choosing an invoice period of 61 days or less would not be a "scheme" within the meaning of section 323A(2)(b). The effect of the "scheme" is that licensing and disclosure obligations that would apply in the case of 90 day terms will not apply, and the provision would be contravened.

In the Committee's view it is not sufficient to say that based on the vague factors in section 323(3) a court "should not" find that the avoidance of the provisions was not a factor in the decision to implement the 61 day terms scheme.

In another common example, a business may charge a late payment fee in relation to payments that are late without arrangement, but choose to not pay any fee where an instalment plan is agreed to recover arrears. The same business costs exist in relation to the arrears instalment plan. However, the business will typically choose not to impose any charge, solely because to do so would attract the operation of the Code.

The Committee strongly suggests that the current model for the anti-avoidance provision should be discarded and an entirely new model suggested. At the heart of the model should be a question of whether, by implementing a scheme, a person has effected an arrangement which may reasonably be regarded as the economic equivalent of an ASIC Act financial product under which the provider or their associates provide services with the same economic effect as a loan and receives benefits with the same economic effect as interest or credit fees and charges, in circumstances where no exemption would be available under the Code or the NCCP Act.

On any such test it should be clear that (for example) the financial benefit obtained by a property developer of receiving 80% of the agreed purchase price by reason of allowing deferred payment of the remaining 20% without fee is **not** the economic equivalent of the benefit earned by a credit provider from lending even though it is a monetary benefit.

If a limited and targeted anti-avoidance provision on this basis were

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developed, it may be appropriate for penalties to apply to persons knowingly involved in the arrangement.

Given the extremely broad language used to define "credit assistance" and "acting as an intermediary", it is not in the Committee's submission, appropriate for an anti-avoidance provision to be applied to credit activities other than being a lender. It is in the Committee's submission too difficult to develop an appropriate test for what might be activity achieving the "same economic effect" as that exceptionally broad range of behaviours.

## Attachment A - Comments prepared on Schedule 2 before its withdrawal from consideration

1. The Committee notes the email from Christian Mikula of 18 February 2013, announcing that the Government has decided to defer the small business finance reform proposals contained in Schedule 2 of the Bill, on the basis that the Bill's release "*has raised consideration of whether the benefits could be delivered in a more targeted and effective way, through the development of a different model from that in the Phase 2 Bill*".
2. Although we understand that Treasury no longer proposes to formally consult on the model set out in Schedule 2 at this time, we attach comments in this Attachment A that had already been prepared in the hope that they will support the consideration of a more targeted and effective model. The Committee had significant concerns about aspects of the approach taken by Schedule 2.
3. The Committee would be pleased to be consulted and to be of assistance as necessary in the development of any further proposals for regulation of small business lending.

## Schedule 2 – summary of key concerns

### (a) Unintended impact on mortgages and guarantees

As with the proposed investment lending reform, the proposed small business amendments operate by expanding the definition of "credit" in the National Credit Code (**Code**) for the purpose of imposing responsible lending obligations under the National Consumer Credit Protection Act (**NCCP Act**). As such, they would have unintentionally extend the meaning of "mortgage" and "guarantee" to cover mortgages and guarantees given in relation to a small business credit contract or an investment credit contract, and extend the operation of the Code in relation to such mortgages and guarantees. The provisions should be amended so as to not have this effect.

### (b) Small business loan - "exit strategy" provision should be alternative, not cumulative

The unsuitability test in relation to small business loans as drafted would have been likely to lead to the great majority of protected small business loans assessed as "unsuitable" because they require the security provider to hold the view that they are prepared to risk losing the residential home while **also** believing that the small business credit contract will allow them to improve their position on sale. As drafted, both of these must be satisfied. It should be sufficient if **either** of them is satisfied.

### (c) Small business definition - exclude businesses in connection with a business that is not a small business

The proposed "headcount based" definition of small business differs from the Chapter 7 Corporations Act test by not excluding a small business that is part of a business that is not a small business (such as a subsidiary which itself has no employees of a large listed company). It should be conformed to the Corporations Act test, or alternatively made consistent with the so called "turnover" test in the ATO's simplified tax system rules (under those rules a business is a small business entity if it carries on a business and has an aggregated turnover of less than \$2 million).

Attachment - Comments prepared on Schedule 2 before its withdrawal from consideration

(d) **Small business exemption - \$5 million may be too high and no justification for requiring each separate facility to exceed the limit**

The Committee submits that (outside of the context of property development) \$5 million is a very substantial amount for a small business loan, and a smaller amount may be suitable as the threshold for regulation. Further, there appears to be no reason in principle why a financier that agrees (at one time) to provide over \$5 million to a small business but under 2 or more separate facilities should be regulated.

(e) **Protected small business loans uncertain**

A protected small business credit contract will exist where there is a "defaulting loan". However, there is no concept of materiality to distinguish between loans that are materially in default, where enforcement action is likely or seriously contemplated, and defaulting loans where enforcement action is unlikely. Further, it may not be apparent to a lender or credit assistance provider until quite late in the process that a relevant loan is a protected small business loan, making compliance with the obligation to provide a quote difficult or impossible.

(f) **Quote provisions**

The Committee submits that a range of exemptions and modifications in relation to quotes will need to be replicated for the small business credit contract provisions. Further, while it may be appropriate to ban the receipt of full payment in advance, the Committee does not see any reason in principle why a capped part payment (for example, covering bona fide third party expenses such as valuation) should not be permitted.

## Schedule 2 – Small business lending

Schedule 2

Explanation that Schedule 1 has not been circulated for public comment with the other Schedules, as it provides for matters relevant to a referral of legislative power to the Commonwealth by the States.

Noted. The Committee would be pleased to be consulted as necessary on technical aspects relating to proposed referral legislation.

Item 1, subsection 5(1)

Use of a definition of 'small business' based on the number of its employees.

The Committee notes that the definition of "small business" is similar to a range of other statutory regimes and industry codes of practice (such as the Code of Banking Practice) which have not been shown to be inappropriate, although using a full-time employee equivalent measure rather than "employees" may add to certainty and promote equality of treatment.

However, the Committee strongly believes that an equivalent definition to that used elsewhere (and drafted in the same terms) should be used.

The relevant definition in section 761G(12) as affected by the balance of section 761G of the Corporations Act would be an appropriate alternative. That section effectively excludes a business that would otherwise be regarded as a small business on the "headcount" test, if it acquires services in connection with a business that is not a small business. (The Code of Banking Practice is to similar effect.) It should equally be noted that the exceptions to "small business" in section 761G are in effect cumulative with other provisions, so that an entity with less than 20 employees will nevertheless not be a retail client if it has assets in

excess of \$2.5 million or income in excess of \$250,000. Some asset or income based test would in the submission of the Committee be appropriate in addition to the "headcount" test.

There are a range of companies within corporate groups which may have very substantial operations but have a small number of employees (or no employees). In general, it would be inappropriate for small loans to these companies to face regulation (particularly as those loans would typically be within a corporate group structure).

For example, a service company owned by an ADI may have employees seconded to it from the ADI (or simply own equipment and have no staff at all) and be supported by loans from the ADI. In our submission it would not be appropriate for the NCCP Act to apply to such a loan. Unless the definition of "small business" is amended as suggested, that outcome would apply.

#### **Need for "reasonable enquiries" provision**

The Committee strongly supports the inclusion of measures which will provide reasonable certainty to credit providers dealing with entities on the basis that they are not small businesses, where reasonable enquiries have been made. A "non-small business" declaration regime, similar to the current business purpose declaration, may be a suitable model.

Item 2, subsection  
5(1A)

Draft Credit Regulation 58A (released with the draft of the Bill) exemption to exclude small business credit contracts where the maximum amount of credit exceeds \$5 million.

The Committee supports having a clear boundary above which loans would not be regulated.

However the Committee believes that the proposed exemption is not sufficiently clear. In particular, the position of a facility that during its life may be above or below the threshold should be considered.

Further, the Committee submits that it will be appropriate to apply a "portfolio" approach to the exposures. If a financier proposes to supply (say) a \$2.6 million finance lease facility, a \$2 million capital loan facility and a \$500,000 working capital facility, it should not matter whether the facility was provided under separate agreements or a single agreement.

Further, the Committee queries why a limit of \$5 million was selected. The Committee submits that a smaller threshold (such as \$1 million) may be as suitable. \$1 million is a very substantial sum of money when used for operational expenses rather than being invested in real property.

\$5 million was selected as the threshold for determining when a residential property development should fall outside NCC regulation under Regulation 65C, but this does not in the Committee's view mean that \$5 million is necessarily the appropriate level at which loans should be treated as having a lower level of regulation (where not given in connection with the acquisition of real property).

#### **Permit mechanics**

The questions raised by Treasury also seek comment on proposed regulations containing the regime for "permits" in relation to small business lending.

On the basis that the permits are intended to be permanent (as opposed

to the transitional "credit registered person" regime), the Committee submits that it might be more appropriate for the basic provisions relating to permits and the need to hold one to be implemented in the primary legislation rather than under regulations.

**Penalties in draft Act and Regulations**

Further, the Committee queries whether any evidence was assessed in stipulating for the proposed penalties (that is, 2,000 penalty units (\$1.7 million civil penalty) and 200 penalty units / 2 years prison for providing the very broadly and loosely defined "credit assistance" without a permit).

The Committee notes with regret that the credit legislation (as with much recent legislation affecting the financial sector) tends to provide for penalties set broadly across-the-board for breaches of a wide range of (in many cases) highly technical requirements, at a level that is wholly disproportionate to the harm likely to be caused in most cases by a breach of the relevant provision, and with no or limited guidance given to Courts on how to assess what level of penalty should be applied in a particular case, and (perhaps) limited prospects of these disproportionate penalties actually being imposed.

The Committee strongly believes that the entire approach to stipulating breaches in financial laws should be reassessed, and the penalties in the proposed Regulation would be an appropriate place to begin that reassessment.

Item 6, subsection 170(1)

Whether there are any classes of small business consumer leases that should be exempted, whether on the basis of the cash value of the leased goods or other characteristics.

Further to the comments above, the Committee submits that it would be appropriate in principle to exempt small business consumer leases for very high value goods from the NCCP Act regime, however the Committee is not aware whether arrangements that would fall within the definition of "consumer lease" are in fact common in the small business space. Finance leases are likely to be more common, which would generally be treated as deemed credit facilities under the Code.

Items 12 and 13, sections 112B and 125B

Explanation that responsible lending obligations do not apply to small business credit contracts generally, but only to protected small business credit contracts.

Noted.

The Committee notes that Divisions 2 and 3 reflect the NCCP Act's distinction between Part 3-1 credit assistance providers and Part 3-2 credit providers. However, there appears to be no equivalent off section 112.

An equivalent of section 112 should be included in Division 2 of Part 3-2F, so that a credit provider is not obliged to perform a section 133FD inquiry in addition to the section 133FI inquiry that they must make as a credit provider.

Item 18, section 133FB

Definition of a 'protected small business credit contract' (a class of contracts to which modified responsible lending obligations would apply).

The Committee agrees that in many cases it may not be reasonably ascertainable by the credit provider that a small business credit applicant is in breach of another credit facility at all, or (if it does become apparent) until quite late in the application process.

It is in the Committee's view likely to be a not uncommon occurrence that a proposed loan's status as a "protected small business credit contract" would not be ascertained until well after the time that section 133FC would require a quote to be provided, and until well after the time that fees might be charged (which would be forbidden under section 133FC(6)).

The Committee does not see a ready solution to this issue. In the Committee's view, it would not be appropriate to require credit providers and other credit service providers to do extensive due diligence on all potential borrowers before being able to ascertain whether they would be able to charge for their expenses in doing so.

**Immaterial breaches**

Further, the definition hinges on whether the consumer had failed to comply with the consumer's financial obligations under the defaulting contract ".

The Committee submits that this requirement should be appropriately qualified so that the relevant failure to comply with financial obligations is material, is current or is likely to recur, and has not been remedied. There are a wide range of financial obligations under commercial loan facilities, and trivial or cured breaches should not raise the prospect that a refinance in the ordinary course of the small business consumer's business, would be subject to more stringent requirements.

Item 18, section 133FC

Requirement for a provider of credit assistance to provide a quote, in relation to small business credit contracts.

We refer to our comments above in relation to the provision of a quote in relation to investment credit contracts:

- it should in our submission be made clear that Subdivision 2 does not apply to the credit provider for the same reasons given in relation to quotes for small business credit contracts;
- the penalties appear disproportionate and should be reviewed for the same reasons given in relation to quotes for small business credit contracts;
- the quote mechanism should not in our view apply to intermediaries for the same reasons given in relation to quotes for small business credit contracts; and
- quotes should not be required where no fee will be charged.

Further, the Committee notes that, unlike section 114 which applies to a "credit licensee", proposed section 133FC applies to a "person", meaning that a range of businesses that are not primarily credit focussed would need to assess whether activity (such as assisting a customer to dial a credit provider, or handing over a brochure) crossed the line into "assistance" or "suggesting".

Item 18, Part 2,

Inquiries that a provider of credit assistance would be required to make, to

Division 2, Subdivision  
B

ensure that a protected small business credit contract is suitable, including that the borrower has an exit strategy, and the consequences of such a contract being unsuitable.

### "Equity stripping"

The Committee agrees that the practice known as "equity stripping" may be a proper subject for legislative intervention, proportionate to the extent of the practice. However, as noted above, the definition of "protected small business loan" potentially extends to loans with immaterial or transitory non-compliance. That definition should, in the Committee's view, be amended if the substantive provisions are to effect their intended aim in a proportionate fashion.

### KEY ISSUE - The borrower's exit strategy defined on alternative grounds

As drafted, a protected small business loan will be "unsuitable" in two cases:

- if the security provider is not prepared to lose their residence, or
- if the security provider "does not think that entering into, or increasing the credit limit of, the contract will enable the consumer or other person to obtain a higher price from the sale of that property "

These are presented as alternative bases for a finding that a loan is unsuitable. If either is false, the loan will be unsuitable (s 133FF(2), s 133FK(2)). However, it appears to the Committee that in many cases where one of the bases is true, the other will be false as a consequence. It would follow that perhaps the great majority of loans will be deemed unsuitable where the security provider is prepared to lose their residence (where they do not hold the requisite belief as to higher price), and equally where the security provider **does** hold the relevant view but is not prepared to lose the residence.

The Committee strongly submits that the relevant provisions should be redrafted so that if the security provider generally holds one of the relevant intentions, then it is not necessary to consider whether they hold or do not hold the alternative.

### Hardship relief

The Committee notes with concern section 133FG(6), which provides that a defence to the civil penalty offence of recommending that a small business consumer remain in an unsuitable contract - where the "defaulting contract" mentioned in 133FB(3)(b) is a "credit contract" is to inform them of the availability of hardship relief under sections 72 and 94. The concern arises because the Committee believes that small business credit contracts (as well as investment credit contracts) will all be "credit contracts" as defined in section 5, even though that hardship relief does not apply to small business credit contracts (because of section 203D) (nor to investment credit contracts, because of section 203C). The reference to "credit contract" should be to a "credit contract (other than a small business credit contract or an investment credit contract)", or perhaps to "a credit contract to which section 72 and section 94 apply".

The Committee notes that there is no intention to apply the section 72 and 94 hardship regime to small business loans and submits that the text

	<p>should make this decision clear.</p> <p>Please also see the Committee's key issue at Item 18 below.</p>
<p>Item 18, section 133FH</p>	<p>Disclosure requirements to apply to credit providers in respect of small business credit contracts.</p> <p><b>Disproportionate penalties</b></p> <p>The Committee repeats its comment that the proposed penalty of A\$1.7 million per contravention is wholly disproportionate to the mischief that is sought to be addressed and suggests that it be reviewed.</p> <p><b>Disclosure of future matters - assumptions</b></p> <p>To be effective, any obligation to disclose matters about the expected future behaviour of the loan such as repayments or interest payable must be able to be made upon specified assumptions as to future events such as under Regulation 28G(5) or Regulations 180 to 182. The specific assumptions that may be made will need to be available well in advance of the commencement date to allow automation of the disclosure documents.</p> <p><b>Disclosures based on Code disclosures</b></p> <p>In general the Committee supports the selection of matters already included in disclosures under the NCC as this should minimise the system work necessary to prepare relevant documents.</p> <p>It should however be recognised that preparing new disclosure documents is likely to involve complex system development and adequate time needs to be allowed for financial institutions to develop and implement relevant disclosure documents.</p>
<p>Item 18, Part 2, Division 3, Subdivision B</p>	<p>Inquiries that a credit provider would be required to make, to ensure that a protected small business credit contract is suitable, including that the borrower has an exit strategy, and, the consequences of such a contract being unsuitable.</p> <p><b>KEY ISSUE - The borrower's exit strategy defined on alternative grounds</b></p> <p>We refer to our comment on Item 18. The "is not prepared to lose the residence" criterion cannot be presented as an alternative requirement to the "does not expect an increased return" criterion so that if either is untrue a loan will be "unsuitable". A loan should be relevantly suitable if either is true.</p> <p><b>Application of Division 2 and Division 3 to the credit provider</b></p> <p>As noted above, the Committee believes that there should be an express disapplication of the requirements of Division 2 from the credit provider.</p> <p><b>Equity stripping focus</b></p> <p>As noted above the definition of "protected small business credit contract" should be amended to ensure that it is actually targeted at cases where there is a real prospect of equity stripping risk.</p>
<p>Item 22, Part 3-4A, Division 1</p>	<p>Whether there is a class of small business consumer leases where providers of credit services or lessors should be subject to responsible</p>

	<p>lending obligations (similar to those proposed to apply to protected small business credit contracts).</p>
	<p>The Committee is not aware whether the issues raised by Part 3-3A would arise in a small business context but believes that the basis for Treasury's expressed view that the same issues would not apply appears sound.</p>
Item 22, Division 2, section 156AB	<p>Requirement for a provider of credit assistance to provide a quote, in relation to small business consumer leases.</p>
	<p>We refer to our comments on Item 18, section 133FC, above.</p>
Item 22, Division 3, section 156AC	<p>Disclosure requirements for lessors in respect of small business consumer leases.</p>
	<p>We refer to our comments on Item 18, section 133FH, above.</p>
Item 24, Division 5, section 203D	<p>Explanation of operation of the provision that excludes the substantive obligations in the National Credit Code from applying to both small business credit contracts and small business consumer leases.</p>
	<p>The Committee refers to its commentary on the equivalent provision in relation to small business lending.</p> <p>The provisions as drafted appear to have an unintended consequence of applying the Code requirements for mortgages and guarantees to any mortgage or guarantee of an investment credit contract, even though investment credit contracts are intended to be exempt from all Code requirements other than the unjust contract provisions.</p> <p>Despite proposed Items 23 and 24 perhaps demonstrating an intention that "credit contract" not include small business credit contracts, they do not in terms amend the relevant definition. (Further, they do not clarify how or where the insertion "credit contracts (other than small business credit contracts)" is intended to fit between the existing heading of section 5 and the existing heading of section 5(1).)</p> <p>Either the section 5 definition of "credit contract" should be amended to exclude investment credit contracts, or proposed section 203C should be amended to exclude mortgages and guarantees (to the extent that they secure obligations under an investment credit contract but not otherwise).</p> <p>With respect, the Committee's personnel are very experienced in working with the NCCP Act and Code and found the way in the proposed Phase 2 amendments have been proposed to be genuinely confusing. The Committee strongly suggests that if the main purpose of the Schedule 2 "small business" changes is to implement responsible lending requirements under the NCCP Act (limited to enquiring whether the principal is willing to risk their residence) while the relevant contracts are to be exempt from the substantive provisions of the Code, it would be more straightforward and elegant to include all of the relevant definitions in the NCCP Act and refrain from amending the Code for this purpose..</p>