

10 October 2016

Ms Jenny Peachey
Executive General Manager – Strategic Review
Financial Ombudsman Service
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Dear Ms Peachey,

Expansion of Financial Ombudsman Service (FOS) Small Business Jurisdiction Submission

The Australian Bankers' Association (**ABA**) welcomes the review of the FOS's small business jurisdiction and is pleased to provide its submission on the matters outlined in the FOS's Small Business Jurisdiction Consultation Paper (**the consultation paper**).

With the active participation of 25 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

Opening comments

On 21 April 2016, the banking industry announced a package of reforms to further protect consumer interests, increase transparency and accountability, and build trust and confidence in banks.

As part of this reform package, the industry supports a broadening of External Dispute Resolution (**EDR**) schemes, with the overall objective of strengthening its current commitment to customers and improving the standards of practice and service in the banking industry. The banking industry believes any reforms of external dispute resolution should focus on simplicity, accessibility and efficiency of the system for small businesses.

The ABA provides comment on the questions and proposed reforms to the Terms of Reference (**ToR**) set out in the consultation paper. The ABA is aware of other current reviews into small business lending, including the Government appointed Ramsay Review in Dispute Resolution and Complaints Framework¹ and the review being undertaken by the Small Business and Family Enterprise Ombudsman.

The ABA believes it would be prudent for FOS to wait until the Australian Government has decided on changes to the broader EDR system before implementing changes to the FOS's ToR. This will reduce unnecessary confusion for small businesses and unnecessary compliance costs for banks.

Proposal to expand jurisdiction for small business credit

Summary of position

- As a general principle, we support FOS having an appropriate jurisdiction to consider and make determinations in relation to credit provided by a Financial Services Provider (**FSP**) to a small business.

¹ <http://treasury.gov.au/ConsultationsandReviews/Reviews/2016/Review-into-Dispute-Resolution-and-Complaints-Framework>



- The ABA suggests that a test is important to assess if the size of the business and its financial position mean the court system is better placed to adjudicate the dispute (refer definition of small business). We support an increase to the eligibility thresholds and monetary limits of the FOS scheme so it is accessible to genuine small businesses and compensation is meaningful, taking account of FOS's mandate to resolve less complex disputes.
- We believe that FOS should have scope to consider ordering variations to SBCF in the case of financial hardship (proposal 2.1). For this purpose, the definition of Credit Contract (as defined in ToR) should be expanded to include credit contracts not regulated under the National Consumer Credit Protection regime.
- The ABA seeks clarification on whether FOS is proposing two classes of disputes. Could FOS explain the difference between 'Small Business Credit Facility disputes' (**SBCF disputes**) and 'debt- related Small Business Credit Facility' dispute? Is there a SBCF dispute that is not debt-related?

Definition of small business

The ABA supports FOS having an appropriate jurisdiction to consider and make determinations in relation to credit facilities provided by a FSP to SBCF disputes. There are a number of definitions of small business utilised in legislation and regulations, by the Government and other bodies, none of which are consistently used (refer Appendix 1).

The ABA suggests the standing of a small business should be assessed against a clear definition of 'small business' that takes into account:

- The number of employees
- Business turnover
- Size of the loan or investment for business purposes, and
- Total credit exposure of the business group.

The ABA suggests that a test is important to assess if the size of the business and its financial position mean the court system is better placed to adjudicate the dispute. This will improve the efficiency and access to EDR for small businesses and reflects the intention that EDR is an alternative dispute resolution process for disputes, other than those that are more suited to be heard in court.

There are a number of small business tests used for legal and commercial purposes. For the purpose of expanding the small business jurisdiction, the ABA proposes the following small business test.

A business is not a small business if one of the following conditions is met:

- The number of employees is 20 people or more, or 100 people or more if the business is or includes the manufacture of good (full-time equivalent); or
- Annual business turnover is \$5 million or more; or
- Size of loan for business purposes is \$3 million or more; or
- Total credit exposure of the business group, including related entities, to all credit providers is \$3-\$5 million or more.

The ABA proposes that these conditions would be applied by FOS to determine whether the applicant's credit dispute should be considered by FOS in accordance with its ToR. A business would not be small if any one of the conditions was satisfied. So, for example, a business with only 19 employees but with an annual turnover of \$15 million would not be classified as a small business. In such a case, we consider that the court system is better placed to adjudicate the matter.



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Having clear thresholds for eligibility will improve the efficiency and accessibility of the scheme for genuine small businesses and reflects the intention that EDR is an alternative dispute resolution process for small and less complex disputes.

The ABA is seeking the opportunity to discuss this proposal further with FOS, in particular an appropriate total credit exposure condition.

Responses to consultation questions

Consultation questions

Proposals 1.1

Do you agree with FOS expanding its small business jurisdiction and proposals 1.1 to 1.3? If not, why not?

Under Proposal 1.1 - Monetary limits, FOS proposes to amend the TOR so as to:

- Increase the jurisdiction claim limit for a SBCF dispute from \$500,00 to \$2 million
- Increase the compensation cap for a claim in a SBCF dispute from \$309,000 to \$2 million
- Increase the credit facility limit for a debt-related SBCF dispute from \$2 million to \$10 million, and
- Prohibit debt recovery proceedings in respect of facilities up to \$10 million while a dispute is being considered by FOS.

Also include in the ToR a definition of the term 'small business credit facility'.

Do you suggest changes to the new monetary limits in Proposal 1.1, and if so, what should the limits be and why?

The ABA supports an appropriate extension of the FOS small business jurisdiction commensurate with the nature of FOS as an industry alternative dispute resolution mechanism. As the report by the Commonwealth Consumer Affairs Advisory Council into the Benchmarks for Industry-based Customer Dispute Resolution Schemes (EDR Benchmarks) observed:

A variety of mechanisms exist to resolve these disputes, including internal dispute resolution and court processes. However, not all dispute resolution processes are suitable or effective in all circumstances. For example, the courts are not always accessible to consumers and internal dispute resolution processes are not always appropriate to resolve a dispute. Alternative dispute resolution (ADR) and industry-based customer dispute resolution schemes provide a further option for customers and businesses to resolve disputes.²

While the ABA supports increasing eligibility thresholds for small business customers, the ABA does not agree with the much higher monetary limits proposed in the consultation paper. Increasing the upper limit as proposed would introduce a significant number of more complex matters and imply a higher level of commercial sophistication and financial capacity beyond that of a small business. Any proposed increases in the monetary limits need to be considered within this context and be appropriate to the facility size that would be required by a 'small business'.

Approximately 98 per cent of small businesses (i.e. businesses with less than 20 employees and annual turnover of less than \$5 million) have loans of less than \$2 million (refer Appendix 2, figure 2.4).

² http://ccaac.gov.au/files/2013/04/CCAAC_FINAL_Benchmarks_Report.pdf at P2



Given that most small business lending is under \$2 million, the ABA is not aware of any empirical justification to increase the credit facility limit for a debt-related SBCF dispute for small businesses from \$2 million to \$10 million.

The characteristics of customers with facilities up to \$2 million differ vastly from customers with facilities up to \$10 million. The former category typically consists of natural persons and retail customers, whereas the latter typically comprise small to medium-sized commercial property developers and broadacre farmers. The transactional sophistication also increases exponentially, with matters at the higher end often involving complex loan documents with business-related covenants, and intricate organisational structures, including the use of trusts and special purpose corporate vehicles. A business with the capacity to service a \$10 million credit facility is therefore likely to be a large, sophisticated business, and should be outside the scope of the protection provided by FOS to small businesses.

Similarly, the proposed cap on compensation awards (\$2 million, an almost six-fold increase from the current cap of \$309,000), is too high given the nature of the small business transactions likely to be considered by FOS, and the lack of appropriate jurisdictional protections, such as rules of evidence and rights of appeal. The ABA supports in principle an increase in the claim and compensation limits to \$1 million and propose that the limits are reviewed after two years of operation to allow sufficient time to assess the effectiveness and efficiency of the new thresholds.

Accordingly, the ABA proposes that FOS consider adopting the following monetary limits:

- Increase the jurisdiction claim limit for a SBCF dispute from \$500,000 to \$1 million
- Increase the compensation cap for a claim in a SBCF dispute from \$309,000 to \$1 million
- Increase the credit facility limit for a debt-related SBCF dispute from \$2 million to \$3 million, and
- Prohibit debt recovery proceedings in respect of facilities up to \$3 million while a dispute is being considered by FOS.

As noted, the ABA is seeking the opportunity to discuss this proposal further with FOS, in particular an appropriate total credit exposure condition.

Additionally, the ABA believes that expanding the small business jurisdiction could result in an increase in more complex cases. FOS will need to have clear criteria for excluding certain cases which would be better dealt with through the court system.

Definition of “Small Business Credit Facility”

The ABA notes that, while FOS proposes to define “Small Business Credit Facility”, it has not included a definition in the consultation paper. The ABA would like clarification of the proposed definition and any effect of this change on FOS’s mandate.

The ABA also seeks clarification on whether FOS is proposing two classes of disputes. Could FOS please explain the difference between ‘Small Business Credit Facility disputes’ and ‘debt-related Small Business Credit Facility’ dispute?

Do you consider that, if Proposal 1.1 is implemented, FOS will also need to make changes to its processes in addition to Proposal 1.2?

If the proposal outlined in 1.1 was implemented, the ABA believes that FOS would need to consider whether its current process will suit resolution of more complex disputes.

For the reasons set out in question 1.1, in particular the credit risk exposure concerns, FOS will have to ensure that the resolution of the dispute is expedited. FOS should take into account all of the circumstances including the actions of other creditors, whether the business is still trading and if so



while it could be insolvent, the rate of financial deterioration of the business and the detriment to the FSP while its rights of enforcement are suspended. It should also be noted that as FOS determinations are not binding on the applicant, recovery could be further delayed if the matter becomes the subject of court proceedings.

Jurisdictional assessments will need to be undertaken efficiently as often the information that is required to assess jurisdiction can take a long time to collate and review. As an example, whether a business is a manufacturer or not (and subject to the 100 employees test) can be a difficult issue to establish that is not always clear cut. The ABA suggests that FOS consider changes to the online dispute form so that a small business has to provide documentation promptly to enable FOS to establish that it has jurisdiction before FOS will progress the dispute.

FOS will need to ensure its staff have the specialised and current knowledge required to deal with complex business lending and a sound knowledge and understanding of bank lending, including prudential obligations of banks. They will also need to have the expertise to expedite these disputes and in accordance with FOS's decision-making jurisdiction.

Finally, FOS makes decisions on the basis of the law, applicable codes, good industry practice and fairness in all the circumstances. The ABA inquires whether FOS should specify the relative weighting of these four factors taking into account the amount of a credit facility or the broader circumstances of the financial situation of the small business. The business may have many creditors, may be trading while insolvent or may be in or on the verge of voluntary administration or receivership when the dispute is lodged.

Under 'Proposal 1.2 Dispute resolution processes' FOS proposes to:

'Provide for paragraph 7.3 to apply to SBCF disputes in a way that allows FOS, when considering such a dispute, to require a party to:

- Attend a compulsory conference, and
- Ensure that a relevant third party also attends the conference'.

FOS may be unable without legislative intervention to implement its proposal to compel a third party to participate in a compulsory conference. Enforceable protections would be required for third parties including privilege, confidentiality and other relevant immunities. This raises the question of how these protections would be enforceable against the parties to the dispute, particularly against the applicant, both during and after the dispute process has ended.

The ABA believes that the participation of a third party in the dispute resolution process including in a compulsory conference of the parties should be voluntary and flexible, for example, allowing third parties to provide information in writing or attend a conference by telephone.

The decision of the third party not to participate should not be taken by FOS to the disadvantage of the case of a party to the dispute.



Under Proposal 1.3 Format of TOR, FOS proposed to “create a new section of the TOR to provide for SBCF disputes. In the new section:

- Explain how the section applies
- Set out provisions of the TOR that only apply to SBCF disputes including –
 - Monetary limit provisions within Proposal 1.1 based on existing provisions paragraphs 5.1o), 5.1r), 9.7, 13.1d) and Schedule 2
 - New dispute resolution provisions within Proposal 1.2, and
- Incorporate by reference the general dispute resolution process provisions in Section C that apply to all dispute types.

Delete paragraphs 5.1r) and 13.1d), which will be incorporated in the new section”.

The ABA is supportive of this approach.

Proposal 2.1: Jurisdiction & remedies

- In paragraph 5.1c) replace ‘Credit Contract’ with ‘credit facility’
- Reword paragraph 9.1b) so that it refers to the forgiveness of debt or variation of a credit facility, and
- Delete paragraph 9.1f).

Do you agree with Proposal 2.1? If not, why not?

It is noted that ‘credit contract’ is to be replaced with ‘credit facility’ in the ToR.

The ABA notes that with the proposed expansion of FOS’ small business credit jurisdiction the existing definition of ‘Credit Contract’ is limited to credit contracts regulated under the National Consumer Credit Protection regime (**NCCP**).

Generally speaking a facility is the means by which something is done or provided. In the case of providing credit, this is facilitated by the credit contract. The approach adopted can vary between FSPs and there can be a number of credit facilities in one contract.

Alternatively, the ABA suggests that the definition of ‘Credit Contract’ could be expanded to include a credit contract with a small business unless there are other provisions of the ToR which apply solely to regulated credit contracts.

If the proposed change to ‘credit facility’ is intended to introduce other connotations the ABA would appreciate the opportunity to discuss this with FOS.

Otherwise, the ABA understands that it is intended that ToR clause 9.1b) will provide FOS with the ability to deal with situations of financial hardship under both regulated and unregulated credit contracts, particularly credit contracts with small businesses.

ToR 9.1b) enables FOS to direct a FSP to take a course of action prescribed under the clause. We believe that FOS should have scope to consider ordering variations to SBCF in the case of financial hardship (proposal 2.1). For this purpose, the definition of Credit Contract (as defined in ToR) as mentioned above should be expanded to include credit contracts not regulated under NCCP regime.



Proposal 3.1: Groups of related bodies corporate

In paragraph 5.1p):

- Replace 'in excess of 20' with '20 or more', and
- Insert 'or more' after '100'.

Do you agree with Proposal 3.1? If not, why not? Would Proposal 3.1 affect your organisation or constituents? Where possible, quantify any impact anticipated and include examples.

The ABA is supportive of the principle to align ToR 5.1p) accordingly. The ABA reiterates our earlier proposal that a change to definition of a 'small business' is included with the ToRs.

Proposal 4.1: Operating an expanded small business jurisdiction

In terms of the operation of an expanded small business jurisdiction, we propose to:

- Establish a separate business unit within our Banking and Finance area staffed by case workers and decision makers with strong expertise and experience in dealing with small business disputes.
- Implement a funding model that will utilise our existing fee structure but will broadly allow for the small business jurisdiction to be 'self-funding'. This might involve a 'small business levy', especially in the early years of operation.

Do you agree with Proposal 4.1? If not, why not?

The ABA agrees with this proposal in principle. In addition to expertise and experience in dealing with small business disputes, it will be essential that these people have or have access to sound knowledge and understanding of bank lending, including prudential obligations of banks.

While a decision is yet to be made about the nature and extent of an expanded small business jurisdiction, would you consider a mid-2017 commencement date for changes to the jurisdiction feasible? If not, why not? If not, what date would be more appropriate and why?

The ABA does not believe a mid-2017 commencement date for changes to the jurisdiction is feasible. Banks generally require 6-12 months for the implementation of significant changes to their compliance and dispute resolution systems. The Australian Government review of EDR schemes, and resulting ToR, is expected to be completed by March 2017. The banking industry also believes it would be prudent to wait until the Government has implemented changes to the broader EDR system. This further time will reduce unnecessary confusion for small business and consumers and unnecessary compliance costs for banks.

Proposal 5: Traditional trustee company services

The ABA does not propose to comment on this item.



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Proposal 6.1 to 6.5: Updates and other amendments

Proposal 6.1

Replace paragraphs 3.1 to 3.3 with a statement to explain that different versions of the TOR apply to disputes depending on when they were lodged.

Proposal 6.2

Amend paragraph 9.7a) so that it simply explains that the maximum total value of the remedy awarded by FOS for a claim in a dispute must not exceed the compensation cap for the claim stated in the schedules to the TOR in force on the dispute's lodgement date.

Proposal 6.3

Where 'Uniform Consumer Credit Code' appears in the TOR, replace it with 'National Credit Code' or 'applicable credit legislation'. Where 'Privacy Commissioner' appears in the TOR, replace it with 'Office of the Australian Information Commissioner'.

Proposal 6.4

Refer to FOS consistently throughout the TOR using the abbreviation 'FOS' unless the pronoun 'we' is more appropriate.

Proposal 6.5

In paragraph 6.1d), replace 'accept the' with 'consider any'.

Consultation question for Proposals 6.1 to 6.5

Do you agree with Proposals 6.1 to 6.5? If not, *why not?*

Proposal 6.1 - Refer to previous comments regarding 3.1-3.3.

Proposal 6.2 - Refer to previous comments with regard to monetary limits.

Proposal 6.3-6.5. The ABA does not propose to comment on these items.

Final comment

The ABA looks forward to further consultation with FOS on these proposals and receipt of draft updated FOS ToR for our review.

If you have any queries please contact Ian Gilbert, Director, Banking Services Regulation on (03) 9852 7976 or igilbert@bankers.asn.au or Amanda Pullinger, Policy Director, Retail Policy on (02) 8298 0411 or apullinger@bankers.asn.au.

Yours sincerely

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Appendix 1 - Defining Small Business

Existing Definitions

There are a number of definitions of small business utilised by the Government and other bodies.

Australian Bureau of Statistics

Small business is defined as a business employing fewer than 20 people.

Australian Taxation Office

In general, a small business entity is a sole trader, partnership, company or trust that has aggregated turnover less than \$2 million.

Unfair Contract Terms Legislation

This legislation offers protection for small businesses, where:

- A business employs less than 20 people, including casual employees employed on a regular and systematic basis), and where
- The upfront price payable under the contract is no more than \$300,000 or \$1 million if the contract is for more than 12 months.

Financial Ombudsman Service

Small business is defined as businesses that have less than 20 employees, or where the business is or includes the manufacture of goods, has less than 100 employees. There is a current facility limit of \$2 million or less for credit disputes where FOS can prevent a financial service provider instituting or pursuing existing debit recovery proceedings. For other disputes small businesses rank as for consumers i.e. \$500,000 claim threshold to access FOS and \$309,000 for compensation.

FOS is currently considering expanding its small business credit jurisdiction. The definition of a small business remains essentially unchanged (a minor wording change), with FOS consulting on a proposed increase to the limit on a small business credit facility dispute that can be considered up to \$10 million, with a claim limit of \$2 million.

Small Business and Family Enterprise Ombudsman

A business is a small business if it has fewer than 100 employees or its annual revenue is \$5 million or less.

The Code of Banking Practice

The definition of small business is the same as used by the FOS, viz a business having less than 20 full time (or equivalent) people, or less than 100 full time (or equivalent) people if the business is or includes the manufacture of goods. For non-credit regulated financial products and services the Code covers the small business if it is a retail client under Ch7 of the Corporations Act (i.e. it not a wholesale client).

Budget

The 2016-17 Budget used a range of definitions of small business to set qualification thresholds for tax cuts and other concessions. The progressive reductions in the company tax rate over 11 years was in the first tranche only applied to business with a turnover threshold of \$2 million. Eligibility for small business concessions such as accelerated depreciation provisions was increased from the current \$2 million turnover threshold to less than \$10 million. Finally, the unincorporated tax discount for small business was increased for businesses with annual turnover less than \$5 million.



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Fair Work Act

A national system employer is a small business employer at a particular time if the employer employs fewer than 15 employees at that time (section 23 of the *Fair Work Act 2009*).

Australian Securities and Investments Commission

A proprietary company is defined as small for a financial year if it satisfies at least two of the following paragraphs:

- the consolidated revenue for the financial year of the company and any entities it controls is less than \$25 million
- the value of the consolidated gross assets at the end of the financial year of the company and any entities it controls is less than \$12.5 million, and
- the company and any entities it controls have fewer than 50 employees at the end of the financial year.

Australian Prudential Regulation Authority

A small business exposure is treated as retail (and not corporate) if the loan exposure is less than \$1 million.



Appendix 2 - Some metrics of the small business sector

2.1 Number of Employees

Businesses with less than 20 employees comprise 97.5 per cent of all businesses in Australia. Under that definition, it is already the case that most businesses in Australia are small businesses.

Figure 1: Business counts

	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
Non–employing	1,306,023	1,306,093	1,264,298	1,273,769	1,284,615
Employing					
1–4	581,741	582,719	563,412	571,206	584,744
5–19	191,812	198,340	197,412	199,965	197,164
20–199	49,302	50,522	50,946	51,619	50,995
200+	3,534	3,606	3,598	3,603	3,717
Total employing	826,389	835,187	815,368	826,393	836,620
Total	2,132,412	2,141,280	2,079,666	2,100,162	2,121,235
. Small	2,079,576	2,087,152	2,025,122	2,044,940	2,066,523
. Medium	49,302	50,522	50,946	51,619	50,995
. Large	3,534	3,606	3,598	3,603	3,717
%distbn					
Non–employing	61.2%	61.0%	60.8%	60.7%	60.6%
Employing					
1–4	27.3%	27.2%	27.1%	27.2%	27.6%
5–19	9.0%	9.3%	9.5%	9.5%	9.3%
20–199	2.3%	2.4%	2.4%	2.5%	2.4%
200+	0.2%	0.2%	0.2%	0.2%	0.2%
Total employing	38.8%	39.0%	39.2%	39.3%	39.4%
Total	100.0%	100.0%	100.0%	100.0%	100.0%
. Small	97.5%	97.5%	97.4%	97.4%	97.4%
. Medium	2.3%	2.4%	2.4%	2.5%	2.4%
. Large	0.2%	0.2%	0.2%	0.2%	0.2%

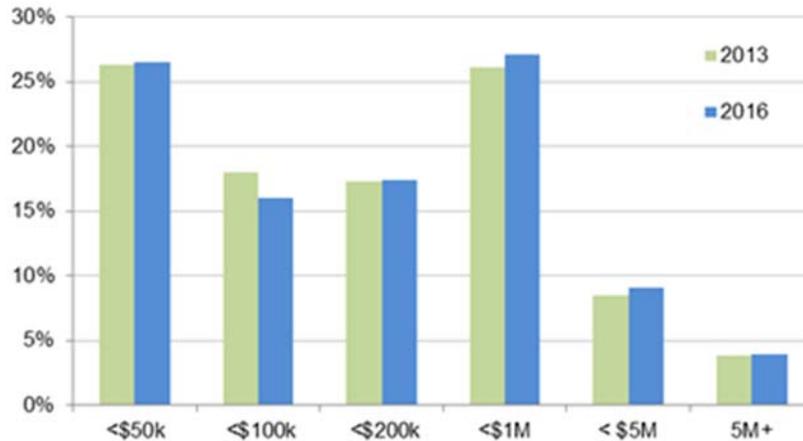
Source: ABS



2.2 Annual Turnover

An annual turnover threshold of \$1 million captures 87 per cent of businesses and \$5 million captures about 96% of businesses.

Figure 2: Businesses by turnover



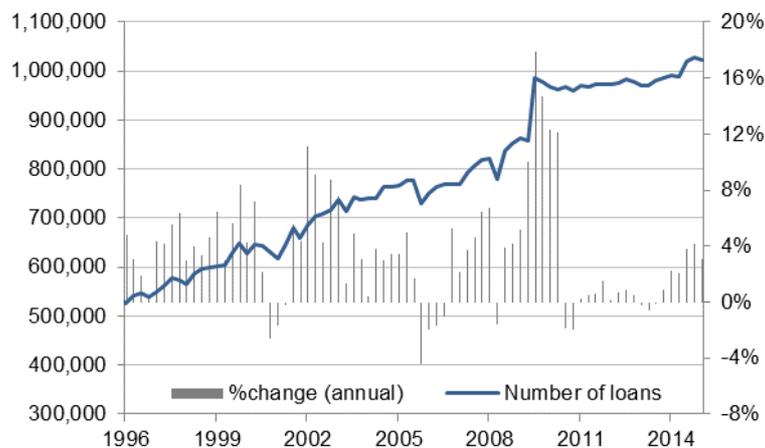
Source: DBM

2.3 Number of business loans

Data on the *number* of business loans are not publicly available, however, estimates by the Australian Bankers' Association (**ABA**) suggest there are just over 1 million business loans under \$2 million.

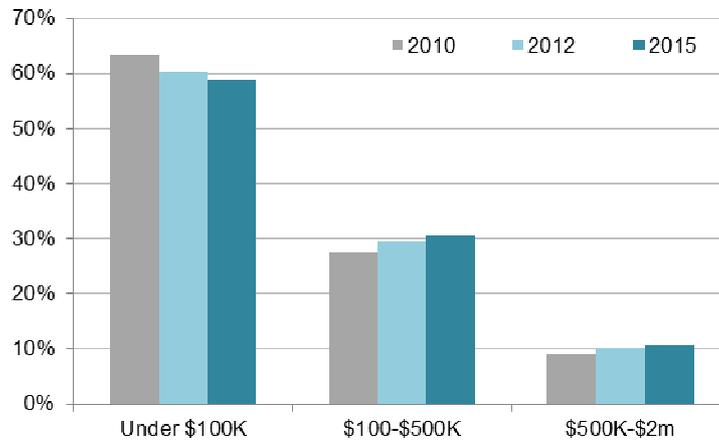
The number of business loans under \$2 million was relatively stable over the four years ending March 2015, but has been rising over the past nine months.

Figure 13: Number of business loans with loan size under \$2 million



Source: RBA/ABA

Figure 14: Distribution of business loans under \$2 million by loan size ranges



Source: ABA/RBA

In 2015, just under 60 per cent of small business loans had a value less than \$100,000. A relatively small number (about ten per cent) were for amounts between \$500,000 and \$2 million.

2.4 Size of Loan Facility

Over 98 per cent of small businesses – those businesses with less than 20 employees and annual turnover of less than \$5 million – have loans of less than \$2 million.

Figure 3: Small businesses by loan outstanding

	Number of loans
More than \$0 but under \$10,000	25.3%
\$10,000 to less than \$50,000	22.4%
\$50,000 to less than \$100,000	10.2%
\$100,000 to less than \$500,000	28.1%
\$500,000 to less than \$1M	9.6%
\$1M to less than \$2M	3.1%
\$2M and over	1.4%
Total	100%

Source: DBM 2013