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By email: JPeachey@FOS.org.au

Dear Jenny,

CONSULTATION PAPER ON EXPANSION OF FOS'S SMALL BUSINESS JURISDICTION

Thank you for the invitation to provide feedback on the *Expansion of FOS's Small Business Jurisdiction Consultation Paper (FOS SME Consultation)* issued by the Financial Ombudsman Service (**FOS**) in August 2016.

The Australian Finance Conference was formed in 1958 as the national association of Finance Companies. It has since evolved into a non-institutionally based association of financiers. Our members include banks, specialist equipment financiers and general financiers providing consumer and commercial credit facilities (including to small business), as well as service providers to the industry: list of members attached in Appendix 2. The AFC also provides a directorate service for a number of finance product-specific industry bodies. These affiliated entities are the Australian Equipment Lessors Association, the Australian Fleet Lessors Association, the Debtor and Invoice Finance Association, and Insurance Premium Financiers of Australia. This submission is made on behalf of the Australian Finance Conference and affiliated entities, collectively referred to as the **AFC**.

Members of the AFC are typically Financial Services Providers, for the purposes of FOS's Terms of Reference (**TOR**), and therefore have a direct and tangible interest in the equitable and efficient operation of the FOS external dispute resolution (**EDR**) regime. As stakeholders in the regime AFC members welcome the opportunity to contribute their views on the possible extension of FOS's small business jurisdiction.

The AFC notes the concurrent work of the independent expert panel (**Expert Panel**) on the financial system EDR framework, of which the FOS is one part. The Expert Panel released on 9 September 2016 an issues paper titled '*Review Of The Financial System External Dispute Resolution Framework*' (**EP Issues Paper**). Outlined in the EP Issues Paper are seven principles which are to guide the Expert Panel's review, namely: efficiency, equity, complexity, transparency, accountability, comparability of outcomes and regulatory costs. As a matter of system integrity the AFC considers that these same principles should similarly be applied when assessing the merit of the proposals in the FOS SME Consultation. The AFC has prepared its submission on this basis.

As a matter of process the AFC also has some concern that the FOS SME Consultation conflates into a single consultation two distinct, but related, issues which should be subject to separate consultative processes. The first issue is whether or not FOS's jurisdiction should be expanded to include a larger number of small businesses. The second and subsequent issue is if a formal decision is reached, what changes need to be made to FOS' legal and operational structure.

The risk of conflating the two deliberations into a single exercise is that the ramifications of the change, if made, might not be fully considered. For example, the current TOR is rather broad in nature and tends to be interpreted in a certain way on a rather ad hoc, case by case, basis. If FOS' small business jurisdiction were expanded it may be appropriate for the TOR to be redrafted in its entirety using more prescriptive and tighter language. This might be needed to accommodate the distinctions between banks and other financiers and consumers and small businesses and which regulations and legislation governs which. However, nowhere in the FOS SME Consultation is this possibility considered. The inclusion of potentially worthy, but extraneous, changes to the issue of whether FOS' small business jurisdiction in the FOS SME Consultation only further muddies the process.

Before turning to AFC's specific comments in the context of this Consultation, it would be remiss not to take a broader perspective and ask whether FOS should now have an SME jurisdiction at all. In the late 1980s when FOS's progenitor (the ABIO) was established, finance regulation was state-based as were the Fair Trading/Consumer Affairs Government agencies and the vital role small business plays in the modern economy was barely recognized. In volunteering into the ABIO, its members consciously ceded several of their legal and contractual rights and remedies to promote an improved consumer outcome.

For several years now, finance and related fair trading regulation have been at the Commonwealth level as are the regulators in ASIC and ACCC. The importance of SMEs is now widely promoted and EDRS 'membership' is compulsory as an ACL or AFSL condition. Moreover there is now an increasingly resourced and mandated Australian Small Business & Family Enterprise Ombudsman, as well as several State Small Business Ombudsman services.

Executive Summary

The AFR considers that:

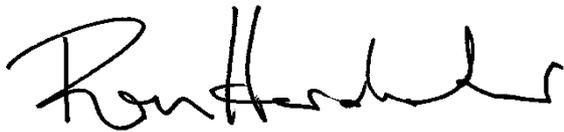
- (i) FOS should remove its existing Small Business definition and replacing it with a financial data based test which accords with contemporary regulatory, business and lending practices and the Expert Panel's guiding principles;
- (ii) the new Small Business test, reflecting the fact that a financier cannot with compliance certainty identify the number of a borrower's employees (even at the outset), be a single turnover test which limits eligibility to a business with an annual turnover of no more than \$2m for reasons of simplicity and to align with the taxation system;
- (iii) the current monetary limits in relation to small business disputes should remain unchanged (Proposal 1);
- (iv) FOS should not have the power to compulsorily force third party attendance at conferences (Proposal 1.2);
- (v) FOS' jurisdiction should not be increased to vary unregulated contracts for financial hardship, absent a compelling reason to do so (Proposal 2.1);

- (vi) any proposal to increase FOS's jurisdiction to vary unregulated contracts for financial hardship should be subject to a separate consultation since the proposal is not restricted to unregulated contracts to small business (Proposal 2.1);
- (vii) its existing grouping provision should be removed and replaced with a provision which is consistent with the new Small Business definition recommended in (i) above (Proposal 3.1);
- (viii) the proposed changes to the existing grouping provision are appropriate if the existing Small Business definition is not replaced (Proposal 3.1);
- (ix) there is no reason for FOS to establish an additional specialist unit and impose additional fees in the event its small business jurisdiction is increased (Proposal 4.1); and
- (x) the proposed changes in respect of paid agents is a useful step forward, but they are unrelated to the proposed small business jurisdiction extension. The actions of paid agents pose systemic issues to the overall FOS EDR regime. The proposed changes should be more fully considered as a part of a separate and broader consultation into the role of paid agents within the FOS EDR regime (Proposal 6.5).

The reasons why AFC has reached these conclusions and recommendations are given in the body of the submission contained in Appendix 1.

If you have any queries in relation to the AFC submission please do not hesitate to contact me on (02) 9231 5877 or Paul Stacey, Associate Director – Policy on (02) 9225 3810.

Yours truly,

A handwritten signature in black ink, appearing to read 'Ron Hardaker', written in a cursive style.

Ron Hardaker
Executive Director

APPENDIX 1

Submission

1. Existing definition of Small Business is no longer appropriate

1.1 Paragraph 20.1 of the TOR defines Small Business as follows:

“Small Business” means a business that, at the time of the act or omission by the Financial Services Provider that gave rise to the Dispute:

- a) if the business is or includes the manufacture of goods: had less than 100 employees; or*
- b) otherwise: had less than 20 employees.*

1.2 The paragraph 20.1, TOR definition of Small Business appears to have been adopted, with minor contextual variation, from section 12BC(2) of the *Australian Securities and Investments Corporation Act 2001 (ASIC 2001 Act)*, which provides:

(2) For the purposes of subsection (1):

small business means a business employing less than:

- (a) if the business is or includes the manufacture of goods—100 people; or*
- (b) otherwise—20 people.*

1.3 Two observations can usefully be made in respect of this statutory definition of small business in the context of the FOS SME Consultation:

- (a) the section 12BC(2) definition was incorporated into the ASIC 2001 Act in its entirety and without alteration from the predecessor *Australian Securities and Investments Commission Act 1989 (ASIC 1989 Act)*.

The statutory definition has therefore existed unaltered, and possibly unconsidered, for at least 15 years and possibly as long as 26 years. However, over this same period there has been significant change in the structure and functioning of the domestic economy – for example, the advent of the digital economy, increased outsourcing and casualization of the workforce. So too there has been significant change to the financial and broader regulatory framework within which businesses operate; and

- (b) the section 12BC(2) definition of small business operates, not in isolation but in conjunction, with “the prescribed amount” of the price of the financial services acquired. The prescribed amount is \$40,000, which is very small in commercial terms, and this limitation applies unless the service is a typical business expense.. The purpose of combining the definitions of small business AND prescribed amount in a single test is to ensure that section 12BC only extends to small businesses whose circumstances are broadly analogous to consumers.

This principle, underpinning the statutory definition from which the FOS definition of small business is drawn, that a consumer based EDR scheme should only be accessed by small businesses who are broadly analogous to consumers must be recalled. It is founded on legitimate concerns of equity, equality and efficiency. For example, in the context of the FOS SME Consultation can it be credibly said the circumstances of a small business who can borrow \$10m are analogous to that of the median Australian employee earning \$80,000 per annum?

1.4 It is usual for business regulators to identify a business, or entity, as small by reference to financial measures. Financial measures have the advantage of being objective and readily available: Examples include:

- (a) taxation regulation. Australia's taxation system provides concessional treatment to small businesses in a number of specific circumstances. Ordinarily a business can only access these if its annual turnover does not exceed \$2 million: see for example the definition of "small business entity", section 328.110, *Income Tax Assessment Act 1997*. Further, the Australian Taxation Office (**ATO**) categorises businesses into market segments by reference to turnover for administrative purposes. For example, "a micro business" is defined as an entity having a turnover between \$75,000 and \$2m. These micro-businesses are arguably those whose business whose circumstances are most broadly analogous to consumers eligible to access the FOS EDR; and
- (b) financial reporting regulation. Small proprietary companies are subject to reduced financial reporting requirements. A proprietary company is small where it satisfies two of a turnover test (of less than \$25m), an assets test (of less than \$12.5m, and an employee test (of less than 50 employees): see section 45A(2), *Corporations Act 2001*. Under this test it is possible for a proprietary company to have 1,000 employees yet still be classified as small and equally for a proprietary company to have 10 employees and not be small.
- 1.5 Turnover and asset tests are therefore incorporated into business accounting and tax systems. These tests determine the amount and character of financial data a business collects, the financial statements it prepares and the income tax liability it reports to the ATO. These tests are therefore of critical importance. The correct application of the tests is ordinarily checked by internal controls and by external audit. In contrast, the number of employees is generally not a relevant measure. Turnover and asset tests are therefore widely understood by commercial people, and regulators, as providing an objective measure of when a business is small.
- 1.6 In the specific context of the financial system turnover and asset tests provide objective, credible and testable evidence of a creditor business's capacity to pay. Credit assessment procedures invariably require a small business applicant to provide details of turnover and assets. The applicant will ordinarily satisfy this requirement by providing a copy of its prior year tax return as lodged with the ATO together with a copy of current and prior year trading accounts. These are then subject to "a debt service exercise" under which the profit and loss account is stress tested by financial modelling to assess capacity to pay.
- 1.7 In contrast, the number of persons employed by an applicant (including other members of a group) has little, to no relevance, in determining the applicant's capacity to service the debt. It is not a relevant measure therefore the data is not collected for credit purposes. Further, even where data on the number of employees is collected it cannot be independently tested again rendering it irrelevant.
- 1.8 The AFC is strongly of the view that the scope of FOS's jurisdiction in respect of small business should only be extended to the extent the enlargement is consistent with the principles of efficiency, equity, complexity, transparency, accountability, comparability of outcomes and regulatory costs. This situation will be met when the circumstances of a small business are broadly analogous to that of a consumer.
- 1.9 The gateway into the FOS EDR system is the initial assessment of credit. At that point both applicant consumers and small businesses are assessed by reference to their capacity to service the debt. In the case of consumers credit lenders require evidence of income and assets. In the case of small business credit lenders require evidence of turnover and assets. It follows, and is in accordance with the principles

of efficiency, equity, complexity and regulatory costs, that gateway test of small business should also be based on turnover.

- 1.10 The AFC therefore recommends that the FOS amend its TOR by removing the existing paragraph 20.1 definition of Small Business and replacing it with a financial data based test which accords with contemporary regulatory, business and lending practices and which accords with the Expert Panel's guiding principles.
- 1.11 For AFC recommends that this new Small Business test be a single turnover test which limits eligibility to a business with an annual turnover of no more than \$2m. AFC recommends that the test be solely based on turnover, and not have regard to assets, for reasons of simplicity. This test aligns to the small business test used in the taxation system and should be applied at the point in time at which credit is extended

2. Proposal 1.1: Increased monetary limits

- 2.1 The FOS SME Consultation proposes to increase the existing monetary limits by a factor of between 4 and 6.47, or in absolute monetary terms to a minimum of \$2m and a maximum of \$10m, depending upon FOS's classification of dispute type.
- 2.2 Paragraph 19 of the EP Issues Paper describes the purpose of an EDR scheme, such as FOS, in the following terms:

“EDR provides an avenue for people to resolve their disputes without going through adversarial court processes. It allows for disputes to be completed in a timelier manner and at a lower cost than the formal legal system. EDR's focus on 'fairness' has the potential to produce results that are more satisfactory to participants. In addition to providing a forum for resolving individual consumer complaints, EDR also allows for the identification and addressing of systemic issues within an industry.”

- 2.3 However, these perceived benefits and potential outcomes come at the detriment of the removal of the due process safeguards of the judicial system. In particular, the absence of the requirement to follow rules of evidence, the common law and the effective removal of appeal rights, except in very limited circumstances. The EDR therefore also has the potential to produce results that are less satisfactory to participants.
- 2.4 At a financial system level the existing policy assessment is that this trade-off is appropriate in circumstances where the complainant is a consumer, or a small business whose circumstances are genuinely analogous to a consumer, and the complainant has also has already gone through an internal dispute resolution (IDR) process.
- 2.5 The underlying reason why this trade-off is appropriate is because the economic resources available to consumers, who are ordinarily individuals, to avail themselves of the judicial system is generally less than those available to credit providers, who are ordinarily businesses. It is this disparity in economic resources which is the primary reason why access to an EDR can result in “timelier” and fairer outcome. It is not because of an inability of the judicial system to provide fair and appropriately timely outcomes. It also follows that the force of the rationale to restrict access to justice via an EDR diminishes together with the decline in the disparity in economic resources.
- 2.6 The AFC agrees with the existing policy assessment that this trade-off is appropriate where the circumstances of a small business are broadly analogous to that of a

consumer, as evidenced by section 12BC of the ASIC 2001. The AFC does not agree with the proposition that small business complainants should be able to restrict access to justice to an EDR where their circumstances are no longer analogous to that of an individual consumer. In this situation the policy rationale restricting access to justice to an EDR no longer applies. The outcome will be the inequitable treatment of the credit provider who is deprived of the protections of the judicial system for no good reason.

- 2.7 The AFC considers that there is no good policy reason, given the rationale of FOS EDS role within the financial system, to increase the existing current monetary limits which are already generous.

3. Proposal 1.2: Right to compel third party attendance at conferences

- 3.1 The FOS SME Consultation notes on page 9 that in FOS's experience of dealing with "small business disputes and other complex matters" conferences are an effective way to help resolve these disputes. Further, and given that complexity, FOS proposes to amend its TOR to give itself the power to make conferences compulsory and to compel third party attendance.

- 3.2 FOS does not outline in the FOS SME Consultation the penalties it proposes to impose on third parties who fail to attend. However, it must necessarily follow that FOS is able to impose penalties if it is to have the power to compel third party attendance. If FOS does not also have the power to impose penalties then logically any third party attendance will not be compulsory.

- 3.3 The AFC agrees with FOS's assessment that small business disputes are "complex matters".

- 3.4 The AFC is deeply concerned, from a rule of law perspective, at the suggestion that FOS confer on itself (by self-amendment of its TOR) judicial powers of subpoena and punishment in order to enable it to deal with that complexity. FOS has no right founded in contract to require attendance since third parties are not a party to the TOR. Therefore, any capacity to require their attendance would be judicial in nature. This suggestion is particularly troubling given the abrogation of judicial rights inherent within the FOS EDR regime.

- 3.5 The AFC is of the view that such a change would likely lead to unfair outcomes and possibly reduced timeliness contrary to the objects of FOS. Proceedings under FOS are without prejudice, do not abide by the rules of evidence, and take complainant submissions on face value. Given these conditions, third parties would be able to make allegations without a burden of proof or risk of being taken to court. This will lead to unfair outcomes to the credit provider. As a practical matter delays may arise due to scheduling difficulties in arranging for a greater number of persons to attend the conference.

- 3.6 The AFC considers that the better view is that given:

- (a) these disputes are complex;
- (b) FOS perceived need to acquire judicial-like powers to deal with that complexity;
- and
- (c) the likelihood that conferment of this power will lead to unfair outcomes

these are all good reasons why small business disputes should continue to be dealt with by the courts

- 3.7 The AFC is strongly of the view that the FOS should not have the power to compulsorily force third party attendance at conferences.
- 4. Proposal 2.1: Extension of jurisdiction to be able to award debt forgiveness or variation for all unregulated contracts (not just with small business) for financial hardship**
- 4.1 The rationale for this proposal, as outlined in page 12 of the FOS SME Consultation, is broadly FOS has this power under the National Credit Code (NCC). Under the Code of Banking Practice (CBP) the banks undertake to have regard to financial hardship. The CBP “reflects good industry practice”. Therefore, the FOS should have the power to vary contracts which are not made to consumers AND which are not regulated under the NCC AND are made by entities others than banks.
- 4.2 This reasoning is patently fallacious. The CBP is, by definition, only indicative of good industry practice for banks. Therefore, by definition, it is not reflective of good industry practice for entities other than banks in other areas of financial services and which appropriately have no input in to development of the CBP. Therefore, by definition, the existence CBP does not provide any support this proposal by FOS. What is inappropriate, though, is for FOS to assess the existence of maladministration in relation to non-bank business lending by reference to criteria which does not apply to that lending, such as the responsible lending and code provisions,
- 4.3 The AFC is also concerned as a matter of process that this proposal is contained within the FOS SME Consultation. Given that the proposal has application beyond credit arrangements with small business the AFC considers it should be subject to a separate consultation process.
- 4.4 The AFC opposes the extension of jurisdiction to award debt forgiveness or vary unregulated contracts for financial hardship given the absence of a compelling argument in support of this proposal.
- 5. Proposal 3.1: Amendment to grouping rule**
- 5.1 The FOS proposes to make a minor amendment to the grouping provision in paragraph 5.1 p) of the TOR so as to better align it with the definition of Small Business in paragraph 20.1 of the TOR.
- 5.2 The AFC is of the view that the definition of Small Business in paragraph 20.1 should be replaced with a financial data based test which accords with contemporary regulatory, business and lending practices and which accords with the Expert Panel’s guiding principles. It follows that AFC considers that the grouping provision in paragraph 5.1 p) should be similarly replaced.
- 5.3 As a general observation the AFC considers that greater guidance could be given as to the time at which grouping should be tested, regardless of whether the test is a financial data based test or an employee number test. That point in time should, broadly, be the point in time at which credit is extended.
- 5.4 The AFC has no objection to the proposal in the event that the definition of Small Business is not improved.

6. Proposal 4.1: Specialist business unit and additional fees

- 6.1 The FOS proposes, at page 14 of the FOS SME Consultation” so establish a “dedicated specialist business unit ... [as a part] of our existing Banking and Finance Team”. To fund the establishment of the unit FOS proposes to level additional fees on credit providers.
- 6.2 The AFC does not support the proposed expansion of FOS jurisdiction in relation to small business in the manner contemplated in the FOS SME Consultation: see paragraphs 1.8 and 2.7.
- 6.3 The AFC agrees with FOS’ view that the small business disputes which currently fall within its jurisdiction are complex: see paragraph 3.1. The AFC does not consider that the complexity of these disputes will increase merely because the monetary limits are increased to the amounts indicated in Proposal 1.1.
- 6.4 If FOS considers it already has the necessary expertise to deal with the small business disputes which fall within its existing jurisdiction AND there is no increase in complexity merely from increasing the monetary limit THEN it follows that there is no need to establish a separate business unit and impose additional costs on credit providers.
- 6.5 Alternatively, if FOS considers that it doesn’t already have the necessary expertise to deal with existing small business disputes, then that is all the more reason why its jurisdiction should not be extended to include a greater number of such disputes. In either case the AFC does not see a convincing reason to establish a separate unit and impose greater costs on business.
- 6.6 The AFC considers there is evidence that the FOS EDR regime is being gamed by paid agents and/or small business customers. As a result of this activity some individuals are able to receive credit which from they otherwise would not be able to obtain via exploiting weaknesses in the system to in effect rewrite their credit histories. The AFC considers that one of the features of the existing FOS EDR regime which enables this gaming, notwithstanding paragraph 6.1d) of the TOR, is the structure of FOS levying fees only one party. Therefore levying yet more fees, without providing additional safeguards, will only result in more gaming of the system. See paragraphs 7.1 to 7.4 for further comment on paid agents.
- 6.7 The AFC does not consider that it is necessary for the FOS to create an additional specialist unit and impose additional fees in the event its jurisdiction in relation to small business disputes is increased.

7. Proposal 6.5: Paid agents

- 7.1 FOS proposes a minor amendment to paragraph 6.1d) of the TOR to reflect that it no longer includes “a separate acceptance step’ in its processes. The amendment is a useful step forward. However, the amendment is also unrelated to the proposed extension of FOS’ small business jurisdiction.
- 7.2 The AFC is of the view that there is evidence that paid agents and their clients are gaming the FOS EDR regime. The AFC considers this gaming is an issue of systemic importance to the financial services EDR regime.
- 7.3 Addressing the systemic risk posed by the actions of some paid agents will require a holistic approach. Necessary measures may include excluding paid agents who

continually abuse the FOS EDR regime, requiring paid agents to pay or contribute to the dispute fee where their claim is unsuccessful etc.

- 7.4 The AFC considers that the range of possible solutions should, as a matter of governance, be considered as a part of a separate and broader review of the role of paid agents within the FOS EDR regime. For this reason AFC recommends that Proposal 6.5 be removed from the FOS SME Consultation and its merits be fully considered in that separate consultation.

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Appendix 2



AFC MEMBER COMPANIES

Allied Credit	Nissan Financial Services
American Express	nlc Pty Ltd
ANZ	Once Australia t/as My Buy
Automotive Financial Services	On Deck Capital
Bank of China	PACCAR Financial
Bank of Melbourne	Pepper Australia Pty Ltd
Bank of Queensland	Qudos Bank
BMW Australia Finance	RABO Equipment Finance
Branded Financial Services	RAC Finance
Capital Finance Australia	RACV Finance
Caterpillar Financial Australia	Ricoh Finance
Classic Funding Group	Selfco Leasing
CNH Industrial	Service Finance Corporation
Commonwealth Bank of Australia	Sharp Finance
Credit Corp Group	St. George Bank
Custom Fleet	Suncorp
De Lage Landen	Suttons Motors
Dun & Bradstreet	Thorn Group/Radio Rentals
Eclix Group	TL Rentals
Experian Asia Pacific	Toyota Financial Services
Finance One	Veda
FlexFleet	Volkswagen Financial Services
FlexiGroup	Volvo Finance
Genworth	Walker Stores
HP Financial Services	Wells Fargo International
Indigenous Business Australia	Westlawn Finance
John Deere Financial	Westpac
Komatsu Corporate Finance	WEX Australia
Kubota Australia Finance	Wingate Consumer Finance
Latitude Financial Services	Yamaha Finance
Leasewise Australia	
Liberty Financial	<u>Professional Associate Members:</u>
Lombard Finance	CHP Consulting
Macquarie Equipment Rentals	Clayton Utz
Macquarie Leasing	Credit Sense Australia
Max Recovery Australia	Dibbs Barker
McMillian Shakespeare Group	Henry Davis York
ME Bank	Sofico Services
Mercedes-Benz Financial Services	White Clarke
MetroFinance	