Comment

Royal Commission Background Papers 10, 11 and 12

Commercial & Asset Finance Brokers Association of Australia

2018

Commercial & Asset Finance Brokers Association of Australia

The Hon Kenneth Hayne AC QC
Commissioner
Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
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Response to Background Papers 10, 11 & 12

The Commercial & Asset Finance Brokers Association of Australia (CAFBA) welcomes the opportunity to share the views of our members with the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The CAFBA team read with interest the Commission's Background Papers 10, 11 and 12 and have worked to provide a combined response in order to assist the Commission with your work. In particular, we focus on **advocating against expanding the *National Consumer Credit Protection Act 2009* (NCCP) to small businesses.**

CAFBA would like to thank the Commission for working to ensure that small business are covered in depth throughout their work. Each Background Paper is well researched and covers most issues well. A key topic that could have been further explored is the range of challenges that small businesses face in gaining access to finance in Australia. As the Carnell Review highlighted, Australia needs to improve its ability to provide small businesses with finances to ensure that our economy continues to strengthen. While brokers play a key role in supporting small businesses to navigate the challenges of accessing finance, more needs to be done to open up new options for finance for small business in Australia.

It is essential that the commission focus on how small business lending is different to general consumer lending. CAFBA welcomes the efforts of consumer groups that advocate for protection of consumers in Australia, in particular those with mortgages. However, it is important for the Commission to focus on the difference between consumer and SME lending. Small business groups in Australia do not want to see increased regulation or the expansion of the NCCP to small business. This could further increase the challenges with access to finance for SMEs.

Further information is provided below. Should you wish to engage with us further on these or other relevant matters, we would be eager to work with you. You can make contact with our team via our CEO, David Gill, on ceo@cafba.com.au.

Yours sincerely,

David Gandolfo
President

Kathryn Bordonaro
Vice President

Background on CAFBA

The Commercial & Asset Finance Brokers Association of Australia (CAFBA) is the peak national body of commercial and equipment finance brokers, whose prime area of business is the distribution of commercial equipment finance facilities to their clients. With over 700 members, in all states and territories, CAFBA is an important national voice in the Australian finance sector.

CAFBA members are career professionals, with recent studies showing nearly 67% (East & Partners 2017) of new commercial equipment finance is sourced through brokers. Our members and their clients are predominantly small to medium sized businesses and operate in the commercial finance market. The total receivables in the Australian equipment finance market are approximately $100 billion, so it is an important component of the Australian economy.

CAFBA members know that providing Australian small businesses with access to finance is crucial to economic growth. Although brokers are commonly associated with home loans, CAFBA members work in a complex environment to provide a boutique service. Without the work of CAFBA's professional members, many Australian small business owners would struggle to navigate the complexities involved with commercial equipment finance.

CAFBA embodies the strengths of its members in a unified approach for dealing with financiers and legislators at a national level and regularly seeks the views of members. As an association, CAFBA provides the framework and support to professionally assist our members in their daily activities. This involves education and training, legislative and regulatory updates and forums where the members can interact and exchange ideas with their peers.

CAFBA prides itself on being self-regulating and maintains strict membership standards on probity, continuing professional development, industry experience, and reputation. It is a condition of CAFBA membership that commercial equipment finance brokers must belong to an ASIC-approved External Dispute Resolution Scheme.

CAFBA is a member of the Council for Small Business Australia and works collaboratively with the government, regulators, and business groups.

Introduction

The Commercial & Asset Finance Brokers Association (CAFBA) has followed the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry with interest. CAFBA members were impressed with each Background Paper and are pleased the Commission is focused on developing a strong understanding of the financial sector in relation to small business and SME lending.

CAFBA members know that it is essential for small businesses in Australia to have access to finance. Small businesses drive our economy and provide employment to millions of Australians. As noted in Background Paper 11 *"External finance plays an important role in providing small businesses with the funds they need to grow and create jobs"* (pp 2).

Our members are particularly concerned to ensure that the Commission does not create a more challenging environment for small business lending in Australia. Background Paper 11 also notes that "The issue of access to finance for SMEs was identified as one of the four main concerns in relation to the flow of funding in the Australian economy by the Financial System Inquiry (FSI) in 2014.[4]" (pp 2). As the Australian Small Business and Family Enterprise Ombudsman outlined in her 2017 *Small Business Loans Inquiry*, there are already a number of barriers that prevent small businesses in Australia from accessing finance. CAFBA believes that the Commission must focus on ways to strengthen small business and SME finance options and avoid recommendations that would result in unnecessary regulation.

While CAFBA recognises the need to protect businesses, it is also important that the Commission see the outcomes that brokers provide. Commercial and asset finance brokers work to support a range of small businesses in Australia to save money, provide far greater product and supplier (bank) choice, and make business finance simple. This allows the owners of small businesses to focus on what matters most to them, growing their business and employing more people.

In particular, CABFA would like to underscore our opposition to the extension of the NCCP to small business and SME lending, discussed further below.

Difference Between Personal and SME Lending

CAFBA believes that the difference between personal and SME lending needs to be both emphasised and understood by the commission. CAFBA upholds the right of all consumers and every business to be protected from unjust practices and to have ready access to fair remedies; however, there is a clear distinction between the needs of consumers and businesses when seeking to borrow money.

In Australia, there are a number of key differences between personal finance, including mortgages, and SME finance, including business lending. It is important to understand the different prudential requirements and the rates at which businesses are able to secure loans.

Key points about the difference:

- While some terminology in commercial and consumer loans is similar, the purpose of loans is entirely different, the customer profile is entirely different, the way is which commercial loans is assessed is entirely different, the outcome for the customer is entirely different, the ongoing relationship between the banker or broker and the business customer is entirely different and the prism through which regulators look at commercial loans must also be entirely different;
- Small business finance is significantly more complex than a mortgage or other personal finance loans;
- Due to their complexity, business finance are more difficult to obtain;
- Small business finance requires more ongoing attention to business progress, cashflow management, issues in the market, fluctuations in demand and consumer sentiment, and other issues;
- Loans for small businesses may need to have a more custom approach than personal finance, requiring negotiated flexibility due to the nature of the business;
- Banks can find business finance far more challenging to process, particularly when engaging with some sectors within small business, and can require support from a broker or other professional;
- Assets used in small business finance can be uncommon;
- There is the potential for banks to incur greater costs in originating and monitoring business loans, due in part to the complexity of the loans and compounded by the risk weighting of business lending (APRA APS 112);
- Small business loans have both a higher risk and probability of default;
- Due to the risk weighting, banks consider business loans in a more in-depth way, examining a range of different factors before allowing a loan to proceed;
- Significantly more information is provided for a business loan, particularly when larger amounts are considered;
- APRA requires that Australian banks hold a higher amount of capital against business loans to allow for absorbing higher expected losses (ARA APS 113);
- Costs associated with business lending are included in the price of a business loan and are completed with a higher risk margin. A higher compliance cost, such as is required on consumer loans under NCCP requirements, would make small business lending even more expensive and prohibitive.

Many businesses in Australia have expressed frustration at the complexity and barriers that they face when seeking a loan. It is essential that we allow small businesses the opportunity to invest, in order to expand their businesses. The recent Finance Round Table convened by the Council of Small Business Organisations of Australia and the Reserve Bank brought together various leaders in small business lending and finance to discuss small business lending. The Round Table heard from a range of businesses who had difficulty in accessing capital for start-up or growth. A key area of agreement at the meeting was that small businesses understand that there are risks involved with business and should be able to take on the risk of a loan to start or expand their business. All business owners represented expressed frustration with their banks and with the level of red tape that already exists.

Quality of Broker Services

The complexity and challenges within SME finance is a key reason why brokers like CAFBA members are so important in the current market. Brokers provide a valuable and professional service, supporting small businesses in Australia to apply for and gain finance that is essential for their business. Brokers are able to help small businesses navigate the complexity of applying for a loan and help to ensure banks understand the small businesses owned by our clients.

It is interesting to note that in the 2017 Annual Report of the Financial Ombudsman Service (FOS) did not find that there were any major issues with business finance, particularly in relation to finance brokers. The Report highlights that in 2017:

- There were 39,479 total disputes
- 58 of these related to finance brokers (0.14%)
- Of the 39,479 disputes only 10% related to business finance
- Of the 3,947 business finance disputes only 39 involved finance brokers

The FOS Report lists systemic trends that need to be monitored and in 2017, no systemic trends reported related to the activities of commercial and asset finance brokers.

Business owners can be disheartened by their bank's lack of understanding of their business, or by their bank's limited range of lending options which may not necessarily suit each funding requirement, giving the potential for inappropriate lending products being taken.

By contrast, commercial finance brokers can quickly connect a business customer with the correct product from a range of different banks and specialist lenders, and provide solutions such as asset finance, trade finance, debtor finance etc, as appropriate, which the business owner would not otherwise have been aware of and which do not use the family home as security.

Professional finance brokers are essential for improving productivity. Brokers reduce the time that businesses spend on gaining access to finance and allow them to spend their valuable time on growing and improving their businesses. CAFBA has a strong commitment to ensuring that all our members are professional and receive and engage in regular professional development to ensure they comply with national standards and regulations.

CAFBA would like to underscore to the Commission the difference between personal, home, and commercial finance brokers. We recognise that brokers have been under pressure in the media through the poor practice by some in other sectors. Despite this, commercial and asset finance brokers are highly regarded in Australia due to their professional conduct. It is essential that we work to maintain this.

CAFBA members arranging business finance as licensees, must meet specified standards and comply with ongoing obligations as follows:

- Meeting general conduct standards, including acting fairly and honestly and managing any conflicts of interest so as not to disadvantage businesses;
- Maintaining their organisation's competence to engage in credit activities, including having responsible managers and adequately trained representatives;
- Maintaining adequate financial resources and risk management systems;
- Meeting responsible lending conduct obligations, including ascertaining and verifying a businesses' financial situation, and assessing whether the credit contract is suitable; and
- Belonging to an ASIC approved EDR scheme and lodging an annual compliance certificate with ASIC.

Support for Existing Reforms & Proposals

CAFBA has supported reforms made to small business lending over the past decade that have supported small businesses. The expansion of unfair contract terms legislation to small businesses is a key reform that CAFBA members support and we are pleased that the major banks in Australia have moved to implement this in their small business lending, in consultation with Kate Carnell as the Australian Small Business and Family Enterprise Ombudsman (ASBFEO). We also support the revised Australian Banking Association's 'The Code of Banking Practice', workshopped in 2017.

CAFBA has always supported reforms that work and are simple. We know that finance is an enabler and that regulation should assist rather than hinder the ability of businesses to expand and grow. Unintended consequences have to be avoided, and any amended or new regulation has to be specifically targeted to areas that actually require improvement, rather than applying broad based "remedies" that simply impose more processes and cost rather than outcomes.

In particular, we would like to emphasise our support for the work of Kate Carnell as in her ASBEFO report on *Small Business Loans*, completed in 2017. CAFBA members believe that the Ombudsman makes a series of logical recommendations that would support small businesses in Australia to both have access to finance and to be protected.

Members of CAFBA often remark that while they support existing reforms, they never have small business clients request additional oversight and regulation for their business banking and finance. The clients of CAFBA members have a simple focus, to grow and improve their businesses. The owners of small businesses in Australia expressed similar sentiments at the COSBOA and Reserve Bank of Australia Round table Discussion on Small Business Finance. Australian small business owners wants simple and effective access to the finance they need.

NCCP

CAFBA acknowledges that the *National Consumer Credit Protection Act 2009* (NCCP) provides important protections to individuals who are taking out personal finance. While the NCCP is appropriate for this setting, small businesses and SME lending is not impacted by the same problems in personal finance and the mortgage sector, as highlighted above.

Background Paper 10 explains the background for a potential NCCP expansion to small businesses. *"One question that has been the subject of debate in recent years is whether the responsible lending regime in the NCCP Act should be extended to small businesses.[14] Under this regime, a bank is required to make reasonable inquiries about a consumer's credit requirements, take reasonable steps to verify the consumer's financial situation and make a 'not unsuitable' assessment.[15] Proposals to extend the responsible lending regime to small business credit have previously been considered but have not been adopted or recommended,[16] mainly due to concerns that such a move would restrict flexibility on the part of lenders and thereby limit access to credit.[17]"* (pp. 5)

It is the view of CAFBA members that expanding the NCCP to small businesses would adversely impact SMEs in Australia. SMEs are vital to our economy, both for employment and tax collection, and need access to finance to survive. Expanding the NCCP to small business would increase the cost of and reduce access to loan finance. This view is shared by others in small business including the Council of Small Business Organisations of Australia (COSBOA), of which CAFBA is a member.

As pointed out in Background Paper 11, when Schedule 2 of the National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012, released for public consultation in 2012, *"small business organisations and the financing and leasing sectors raised concerns with the draft legislation including that:*

- *the regime would result in unnecessary duplication and compliance costs;*
- *the measures would likely restrict lending to small businesses and make the lending process more difficult and expensive for lenders;*
- *small businesses would need to spend more time and resources in order to access finance; and*
- *the measures would not deter unfair credit practices."* (pp. 5)

The Government listened to the views of the small business community in Australia, and instead, other more targeted reforms, such as the extension of unfair contract term protections and reforms to non-monetary covenants were pursued and are discussed in detail in Background Paper 11.

The 2012/13 NCCP expansion legislation is designed to protect small business in distress, whereby they are seeking funds urgently to keep their business afloat and are putting the family home at risk. This is a small percentage of the total market and can be addressed in a more targeted way that wouldn't disadvantage other small businesses or reduce access to finance.

Expanding the NCCP could lead to the standardisation of processes which can close financial niche markets, leading to more challenges for small businesses that do not fit the mould, particularly start-ups. In a nation which is crying out for innovation, regulation should not unnecessarily limit the availability of financial capital.

Why the NCCP won't work for small business credit

Consumer advocates often argue that NCCP regulation should be extended to small business borrowers. But consumer groups advocate for consumers rather than businesses, which is a distinction that needs to be made. Another is that business owners are entrepreneurial and independent by nature and want their business acumen to be respected and for their vision to be understood.

One of the key components of the NCCP is "responsible lending guidelines", which is a prescriptive set of standards under which a consumer's capacity to repay loans is assessed against their fixed income and expenses. The notion that a growing small business with variable income and costs can be assessed on the same basis as a fixed-income salary earner is fundamentally flawed. The application of NCCP-type lending principals on small businesses would be catastrophic for any business wishing to borrow for expansion, as their capacity to repay next year's commitments would be based solely on last year's figures without taking account of the purpose of the loan and the economic benefit that the deployment of extra capital would bring. The broader impact on economic growth and employment would be enormous.

Appropriate regulation for businesses lies in fair contract terms and not in prescriptive lending guidelines. Ongoing improvement in delivery of outcomes for business owners seeking finance will be gained improving education and financial literacy – a space in which CAFBA has taken a leadership role – and not in regulatory processes.

The major risk of adopting wide-ranging reforms like expanding the NCCP is that it widens the regulatory black cloud that hangs over business finance and makes it more difficult to lend.