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9 November 2009

Mr Peter Hallahan
Secretary
Senate Standing Committee on
Legal & Constitutional Affairs
Parliament House
CANBERRA ACT 2600
Email: legcon.sen@aph.gov.au

Dear Mr Hallahan,

**Inquiry into the Personal Property Securities
(Consequential Amendments) Bill 2009**

The Australian Finance Conference (AFC) appreciates the opportunity to provide the accompanying submission to the Senate Standing Committee on the Personal Property Securities (Consequential Amendments) Bill 2009.

We look forward to participating in tomorrow's public hearings, by teleconference at 2.15pm.

Yours truly,

Ron Hardaker
Executive Director

Inquiry into the Personal Property Securities (Consequential Amendments) Bill 2009

1. Executive Summary

- 1.1. The AFC and kindred associations represent more than 100 financial institutions; we have supported the introduction of the PPS regime, appreciating that it will change the way all of them do business. We remain most concerned that the date for registration of a purchase money security interest (PMSI) is triggered by the grantor's possession of the goods, and not by attachment (when funds are advanced).
- 1.2. The financier needs a PMSI registration to protect its security interest. The financier knows with absolute certainty when attachment occurs, but cannot be certain when possession occurs; but if the PMSI registration is ineffective as a result of events outside the financier's control, the financier loses its security entitlement and becomes an unsecured creditor. This is an extreme outcome, and could not occur under the current framework for leasing or hire purchase transactions.
- 1.3. The experience in New Zealand under similar rules is that financiers do not rely on PMSIs, but instead use subordination agreements, a costly and much less efficient mechanism.
- 1.4. The PMSI mechanism is vital in affording the financier the same priority as present, and in encouraging financiers to finance items adding new value to business. In response to our concerns, options available for financiers to manage these difficulties have been advanced, together with arguments to support the use of possession as the trigger. These are very much second best. In the final analysis it is a question of whether the PMSI mechanism is enabled to fulfil its intended purpose of protecting the financier providing new value, and promoting a competitive financial system; to do this the trigger date for PMSI registration needs to relate to attachment.
- 1.5. We have raised this issue repeatedly in our submissions, and the Senate Committee has recommended it be considered by the Attorney-General's Department, but it has not been addressed in the recent amendments.

2. Background

- 2.1. The Australian Finance Conference (AFC) has been a strong supporter of the Personal Property Securities (PPS) regime. Together with our kindred associations, the Australian Equipment Lessors Association and Australian Fleet Lessors Association, we represent in excess of 100 financial institutions operating in Australia.
- 2.1. Our major concern with the proposed legislation is that the 10 business days within which a PMSI must be registered is triggered by the grantor's possession, rather than the date of attachment; this has the potential to fundamentally undermine the efficacy of the PPS regime in relation to equipment finance, and to place leasing and hire purchase in a significantly inferior position than currently. We have raised this issue in all our submissions to the Senate Standing Committee; the Committee has recommended that it be considered by the Attorney-General's Department. Notwithstanding that we have also raised it directly in our submissions to the Department, and with the Attorney-General, it has not been addressed in the current amendments. The need to resolve this issue is highlighted by the experience in New Zealand, as outlined below.

3. THE ISSUE: TRIGGER TIME FOR REGISTRATION OF A PMSI

- 3.1. For goods that are not inventory, a purchase money security interest (PMSI) must be registered within 10 days after the grantor acquires **possession** of the goods. But for the reasons detailed below, to enable PMSIs to fulfil their purpose this should be changed to within 10 days after **attachment**.
- 3.2. Attachment is the time the financier provides the funds. The financier always knows when this occurs, but does not know when possession occurs. Manufacturers/sellers will sometimes give possession prior to funding if the finance has been conditionally approved, but the financier will not know in which cases. Financiers also provide corporate customers with a finance facility under which the grantor is authorised to draw upon to acquire equipment as required; the financier will not be aware of the transaction or the equipment until the relevant documents arrive from the grantor.
- 3.3. Our members advise that uncertainty about the time of possession, together with the extreme consequence of incorrectly registering a PMSI, mean they will not be confident in utilising the PMSI mechanism. Apart from contravening a civil penalty provision of the Bill, to incorrectly register a PMSI voids the whole registration, i.e. not only as a PMSI, but registration altogether; in the event of the customer's insolvency, the financier will be an unsecured creditor.

Example: BankA provides hire purchase finance on 21 October and registers a PMSI against the collateral on 27 October. Unbeknownst to BankA, the grantor took possession of the collateral on 14 October. Because the PMSI was not registered within 10 business days of the grantor obtaining possession, it is ineffective. GrantorA becomes insolvent, and BankA has no recognised security interest in the collateral, and is simply an unsecured creditor. This outcome could not eventuate under the current framework.

4. The consequence of incorrect PMSI registration is extreme

- 4.1. Our members are totally supportive of the PMSI concept itself. Currently under a lease or hire purchase arrangement the financier is the owner of the goods. Accordingly it is not presently necessary for the financier to establish its priority over the asset; the financier holds title, and on insolvency of the customer the asset is not available to other creditors. By contrast, under the PPS regime title becomes irrelevant, and the financier needs to register a PMSI to ensure the same priority over the asset.
- 4.2. The consequence of incorrect PMSI registration is extreme, ie the financier is unsecured. The PMSI mechanism is vital in affording the financier the same degree of priority as presently, and it is also vital in ensuring a competitive and dynamic financial system. Without the PMSI mechanism a new financier would rank behind the party having a security interest in present and after acquired property (the current fixed and floating charge); a new financier would not be prepared to advance funds on this basis, and would require a subordination agreement to be entered into by the first lender. The PMSI is potentially an extremely valuable mechanism for lenders and for a dynamic financial system.

5. The PMSI compliance conundrum

- 5.1. Financiers really want to utilise the PMSI mechanism because of the super-priority it promises, but if the trigger date is possession they cannot be absolutely sure they will validly register, in which case they will have no priority let alone a super-priority. They may obtain advice of delivery (ie, possession) from the supplier or grantor, but in the end this will be a matter of fact; if upon the grantor's insolvency this date is shown to be incorrect, the financier may be in breach of the PMSI registration requirements.
- 5.2. It is this combination of extreme consequence and compliance uncertainty that threatens the efficacy of the PMSI mechanism when the trigger date is possession. The New Zealand experience, where the time for PMSI registration is also based on possession, is that financiers do not rely on PMSIs for non-inventory goods to nearly the extent they should, but rather negotiate a subordination agreement if there is an existing security interest. Our members that operate in New Zealand advise that this would not be the case if PMSI registration was triggered by the date of attachment; they would then use the PMSI mechanism, doing away with the need for subordination agreements.

6. The experience in other PPS jurisdictions

6.1. We recognise that possession rather than attachment is the basis in other jurisdictions. But as noted, in New Zealand this has resulted in the undermining of the fundamental purpose of the PMSI. Possession works well in North America, where the PPS regime originated, because it is the practice for equipment sellers themselves to initially provide the finance and to on-sell this paper to the end financier; accordingly the issue of possession versus attachment does not arise, as the equipment seller is also the financier and knows with certainty the time of possession. This is not the way the Australian market operates and, consistent with the New Zealand experience, the Australian market will not move to such an approach (for one thing, customers like to shop around for finance and not necessarily take up the finance provided by the dealer), but will rely heavily on subordination agreements.

7. Possible options for financiers to manage the compliance uncertainty

7.1. The financier has the option of registering a PMSI prior to attachment, for example when the facility is conditionally approved. This has a number of practical drawbacks, but in the final analysis does not overcome the underlying problem. Where registration depends on the correctness of a serial number, this will often not be known until delivery of the goods thus requiring the interest to be corrected. Furthermore, up to 20% of approved finance applications do not proceed to settlement. Both outcomes necessitate double-handling by financiers, increased costs and increased traffic on the register. But most critically, even if a financier registers before settlement it cannot be guaranteed of PMSI status unless it knows for a fact the date of delivery, so the same fundamental problem as outlined above remains.

8. Arguments for possession difficult to sustain in face of PMSI purpose

8.1. As possession has been in use in North America, we can appreciate the presumption that it would be appropriate for our regime. But as noted our equipment finance market is significantly different in that the seller is not the original financier. Another consideration is the desirability of being able to register a security interest with confidence. This occurs where a grantor acquires goods and subsequently decides to finance them; the prospective financier could therefore wait 10 days, and if a PMSI was not registered in that period, the prospective financier could confidently advance the funds and register their security interest. But transactions of this nature represent a very small proportion of the market; by their nature they automatically fall into the 'high risk' classification and financiers apply more stringent processes to the application to show that the grantor of the security interest is in fact the owner of the goods and entitled to grant the security interest (usually by the grantor providing the financier with an invoice evidencing payment to the supplier for the goods); financiers prefer to pay suppliers direct, as there is more certainty the goods exist and reflect the financier's exposure.

8.2. In the final analysis it becomes a question of whether the legislation should ensure PMSIs fulfil their intended purpose, or whether that purpose should be subjugated to a very small component of the market which already is subject to heightened lender scrutiny. We believe it should be the former, ie the trigger date for PMSI registration should be the time of attachment.
