5 Small business finance

Introduction

Nature of complaints to the Fair Trading inquiry

5.1 The serious business conduct issues relating to small business finance raised in evidence to the Fair Trading inquiry concerned:

- lack of disclosure of the terms of a loan;
- limited client access to information about bank accounts;
- failure of banks and finance companies to live up to their side of loan agreements;
- harsh conduct in relation to repossession and mortgagee sales;
- breach of client confidentiality; and
- banks obstructing dispute resolution by recourse to costly court action.

5.2 The Committee received a large number of submissions from small businesses, including rural producers, about the conduct of financial institutions. Unfortunately, the majority of these submissions were received towards the end of the inquiry and it was not possible to pursue the issues raised at public hearings.[1]

5.3 Many of the submissions focussed on the details of particular disputes, often naming bank officers involved in the negotiation and administration of loans. It was not the purpose of the Fair Trading inquiry to adjudicate particular disputes. For this reason, the Committee received many banking submissions in confidence, either at the request of the author or at the discretion of the Committee. In this chapter, the names of most witnesses have been suppressed by the Committee and issues raised are not attributed.

Financial System Inquiry (the Wallis inquiry)

5.4 As the Committee was considering its recommendations on small business finance, the Treasurer released the report of the Financial System Inquiry, chaired by Mr Stan Wallis.[2]

1 The Australian Bankers' Association (ABA) was provided with a schedule of the types of business conduct issues raised in the inquiry in relation to banks and provided comments (*Submission No. 34.1*).

2 Financial System Inquiry, *Financial System Inquiry Final Report* (March 1997).

5.5 The Wallis inquiry and the Fair Trading inquiry have examined different aspects of small business finance. The focus of the Wallis inquiry in relation to small business was on macro issues such as the availability and cost of small business finance, whereas the focus of the Fair Trading inquiry has been on the business conduct of banks and finance companies.

5.6 Nonetheless, some of the findings and recommendations of the Wallis report are relevant to issues raised in the Fair Trading inquiry.

Wallis findings on small business finance

5.7 In particular, the Committee notes the Wallis findings that small businesses face **higher borrowing costs** and **more onerous loan conditions** than larger businesses, owing in part to:

- the greater risk and smaller scale inherent in lending to small businesses;[3] and
- the greater use by small businesses of flexible loan instruments such as overdraft facilities.[4]

5.8 The Wallis report also observed that **small businesses are more heavily reliant on debt finance** than equity finance and that:

- banks are the main financial institution for 98% of small businesses in Australia;[5]
- the major trading banks are the main financial institution for 78% of small businesses in Australia; [6]
- the most common form of finance to small business is secured bank loans; [7] and
- small business is likely to continue to be reliant on bank finance because of the lack of expertise in small business credit-risk assessment in the non-banking sector.[8]

5.9 These findings are entirely consistent with the composition of complaints to the Fair Trading inquiry, most of which concerned disputes with the major trading banks.

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3 90% of small businesses seeking growth finance apply for loans of less than $500,000. *Financial System Inquiry Final Report*, p. 62.

4 *Financial System Inquiry Final Report*, pp. 511-12.

5 *Financial System Inquiry Final Report*, p. 443. The figures are drawn from the 1995 *Yellow Pages* Survey by Brian Sweeney and Associates. The survey also found that most small businesses only keep accounts with one financial institution; only 15% of small businesses operated accounts with more than one financial institution.

6 *Financial System Inquiry Final Report*, p. 443.

7 *Financial System Inquiry Final Report*, p. 444.

8 *Financial System Inquiry Final Report*, p. 443.

5.10 The financial profile of small business described in the Wallis report suggests that many small businesses are indistinguishable from private retail clients. As a general rule, small businesses are obtaining relatively small loans secured against their personal assets, mainly from banks.

5.11 Over the past decade, the Commonwealth, States and the financial community itself have taken action to protect consumers in their dealings with financial institutions. Yet the small business community has been virtually ignored. Some of the business conduct described later in this chapter would have been in breach of the law or in contravention of industry codes had the customer involved been a private retail customer and not a small business customer.

Wallis recommendations on client protection

5.12 The Wallis report made strong recommendations on protection for consumers. The new authority proposed by the Wallis inquiry - the Corporations and Financial Services Commission - would have a regulatory and enforcement role in relation to the protection of consumers of financial services, would approve industry codes of conduct, and would administer a centralised dispute resolution mechanism for complaints against financial institutions.[9] The Committee notes there is no mention of small businesses being covered in these arrangements. The Committee considers the regulatory distinction between 'private retail' customers and 'small business' customers is artificial.

5.13 The Wallis report did identify a need for the coverage of dispute resolution schemes to be broader and recommended that:

> *All dispute resolution schemes [in the financial sector] should be encouraged to extend their coverage to small business on the basis that the cost of operation should be shared by each party to a dispute.*[10]

5.14 The Wallis report pointed out, as evidence of the pressure for the extension of the Australian Banking Industry Ombudsman scheme to small businesses, that more than 25% of the complaints to the Ombudsman over each of the past three financial years had been dismissed as outside the terms of reference of the scheme because they had come from incorporated (probably small) businesses.[11] The Committee considers the scheme should be extended and picks up this issue later in this chapter.

5.15 The Committee also considers any regulatory scheme set up to protect consumers as a result of the Wallis recommendations should extend to small businesses, and, in particular, that small business disputes should be covered by any financial system dispute resolution mechanism administered by the Commonwealth.

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9 *Financial System Inquiry Final Report*, Recommendations 2, 3, 7, 8, 9, 25.
10 *Financial System Inquiry Final Report*, Recommendation 26.
11 *Financial System Inquiry Final Report*, p. 290.

5.16 Recommendation 5.1

The Committee recommends that small businesses be included in any client protection/dispute resolution programs established by the Treasurer pursuant to the recommendations in the report of the Financial System Inquiry (the Wallis report).

Major categories of disputes with banks

Pre-contract and ongoing disclosure

5.17 It is clear to the Committee that small businesses often have difficulty understanding the terms and conditions of loan agreements they enter into. This is not a criticism of small businesses but rather a recognition of the complexity of financial documentation.

5.18 The Australians for Banking Justice Association submitted:

> *Current documentation is both antiquated and cumbersome and the writer would dare to say that most bank officers are unaware of the pertinence or ramifications of the documents they are signing,* ***let alone could it be anticipated or conceivable that more than 30% of customers will either read or understand what they are signing at the time of signing****. Only in the event of a dispute would the documents be referred to and most probably only then by the customer's legal representatives. Even if the customer does read and understand the 'fine print' he has no bargaining power to suggest an amendment or alter the terms, if he wishes or needs to proceed with the loan.*[12] *[emphasis added]*

5.19 Of more concern to the Committee are allegations that banks and finance companies have exploited clients' lack of familiarity with complex loan documents, by providing misleading information about loan facilities or misrepresenting:

- the terms and conditions of loans provided to small businesses, and
- the form of finance provided, particularly in relation to commercial bill facilities.[13]

5.20 The effect, and alleged purpose, of misrepresentations is to make clients liable for higher interest payments, fees and charges than they expect to pay[14] - 'profiteering from confusion' as one submission put it.[15]

12 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*

13 *Submissions Nos. 148 & 171* both concern small business loans which were represented to be commercial bill facilities but, in fact, were not. In one of these cases, the bank is alleged to have falsely represented that it was also providing a foreign currency loan.

5.21 The Committee received one submission expressing concern that banks have the power to vary repayment terms after negotiation of the loan agreement,[16] and another submission objecting to variable interest rate loans that undermine certainty of contract.[17]

5.22 The Australians for Banking Justice Association submitted there was a need for customers to be provided with copies of all documentation signed and, further, for there to be mandatory disclosure of the following information:

- the Bank's Code of Conduct & Ethics;
- standard practices and procedures affecting the management of client accounts;
- the interest to be charged and the timing of interest payments;
- any account fees applying and the timing of these charges;
- details of dispute resolution mechanisms, the form in which complaints are to be lodged and contact details for lodging complaints; and
- the limit on any personal guarantee applying to the contract.

5.23 The Association also considered that loan documentation should provide for the client to be notified of any changes to the original terms and conditions and for the client to be able to make alternative financing arrangements if such changes are unacceptable. [18]

5.24 In the area of consumer credit, there are strict rules governing the type of information that must be disclosed to potential borrowers and the way in which that information is to be presented. The Committee considers small businesses should be entitled to the same level of disclosure.

14 *Submission No. 171* was received from an astute businessperson who called for expressions of interest in refinancing a string of rural properties. A major trading bank was chosen to refinance after comparison of its offer with packages offered by other financiers. Once the financial relationship with the bank had been finalised, the business discovered that the interest repayments were much higher than represented in negotiations.

15 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*

16 *Submission No. 167.*

17 *Submission No. 163.*

18 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*

Access to account information

5.25 The Committee heard of problems faced by small businesses in seeking to have banks provide information about their accounts. The problems include:

- refusals by banks to disclose information about clients' accounts, even when clients specifically request the information;[19]
- failure of banks to explain how interest has been calculated and/or to provide information on the interest rates applying at different stages of a loan;[20] and
- the practice of banks opening new accounts for clients on their own initiative and transferring credits and debits between accounts without the permission of the clients.[21]

5.26 If small businesses cannot understand the terms and conditions of finance, and if they are obstructed from monitoring the status of accounts, it is more likely they will fall into arrears or otherwise default, with potentially ruinous consequences. In one case brought to the Committee's attention, a bank allegedly ceased to provide account statements to a client and failed to advise the overdraft ceiling, with the result that the client defaulted on a loan facility without knowing the extent of any default. The bank then sold the mortgaged rural properties, resulting in personal and financial devastation for the client.[22]

5.27 The Australians for Banking Justice Association observed that it had received many complaints from customers who had sought access to their files, only to be advised that the files were 'lost' or could not be located. The Association considered this to be a particularly serious matter in light of the fact that particular bank officers could make adverse comments on a client's file as a result of a personality conflict, which could then affect subsequent dealings with the bank and the client's credit reference.[23]

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19 For example, *Submissions Nos. 164 & 165* detail disputes where banks refused to provide clients with information about their accounts when the amounts of interest levied and the outstanding balances were in dispute. In the latter case, the bank refused to explain why an account had been manually adjusted, even when solicitors for the client made a formal request.

20 *Submission No. 164* tells of a loan of $30,000 accruing more than twelve times the amount of the original advance in interest and fees, despite the fact that regular repayments were made on the loan. It is alleged the bank would not explain to the client how interest had been calculated.

21 The Committee received several submissions claiming that banks had opened multiple accounts in relation to one loan facility, without the permission of the client, making it more difficult for the client to track loan repayments and to estimate the balance owing.

22 *Submission No. 171*.

23 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*

5.28 One submission urged the Committee to stop banks 'being secretive and evasive when clients have a right to understand contracts and loans and their position'.[24] The Committee endorses this fundamental principle of fairness. The Code of Banking Practice provides for full disclosure and fair dealing in relation to individual customers accessing banking services for their private or domestic use. The Committee considers all customers should be entitled to such rights.

Failure of banks and finance companies to fulfil obligations to clients

5.29 Another area of concern to small business is the failure of banks and finance companies to provide finance as agreed. It was apparent from evidence to the inquiry that many small businesses regard their financiers as business partners, are prepared to rely on oral assurances that money will be available when required, and feel betrayed when account managers fail to honour promises.

5.30 It was not apparent from submissions to the Fair Trading inquiry that account managers were always acting in the best interests of their clients. Some submissions described circumstances that were indicative of account managers 'losing their nerve' during periods of economic downturn or trying to improve their loan portfolio risk profile by liquidating loans.

5.31 'Relationship' problems in this area included:

- the failure of finance providers to make funds available in accordance with pre-arranged schedules, causing serious damage to small businesses;[25]
- finance providers reneging on oral representations made to clients in loan negotiations;[26]
- selective dishonouring of cheques to clients' suppliers, including when clients were within their overdraft limits;[27]
- harassment of clients to liquidate assets even when clients were not in default on loans - particularly during a general downturn in economic activity;[28]
- requirements for clients to provide further security or mortgages on already secured loans - particularly during economic downturns;[29]

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24 *Submission No. 165.*

25 *Submissions Nos. 108 & 132.*

26 For example, *Submission No. 132* tells how an investor proceeded with a residential subdivision on the basis of assurances from a finance company that it would fund construction. Ultimately, the finance company chose not to back its client to the degree promised; the account manager is claimed to have visited the property and decided that it was attractive for the finance company to repossess and sell what was already in place rather than to assist the client to complete the project. The client suffered financial devastation as a result of this action.

27 *Submissions Nos. 148 & 172.*

28 *Submission No. 137* concerns bank finance for a commercial property. Almost immediately **after** refinancing the enterprise, the bank appointed professional advisers (including accountants) to report on its profitability; the bank then insisted on further mortgages and charges over its client's assets and began to urge the sale of the property.

29 *Submission No. 137.*

- actions taken by banks to hinder or prevent clients from refinancing before or after defaulting on a loan;[30] and
- alleged sales of mortgages (as distinct from mortgaged properties).[31]

5.32 The Committee was urged to make some form of recommendation that would require banks or finance companies to accept liability for the financial consequences of incorrect information given to clients.[32] The general view in submissions was that, if mistakes were made, it was always the client who suffered; the interests of banks and financial institutions are secured in written contracts against real property; clients are often reliant on oral assurances and often cannot afford to take legal action.

5.33 The Committee considers clients should be eligible for compensation or damages where account managers provide incorrect information or wrong advice. The Committee considers this matter should be addressed by providing for:

- better disclosure to small business clients - in writing and not in vague oral representations; and
- fast, low cost dispute resolution mechanisms for small businesses.

5.34 These issues are covered in the Committee's recommendations.

Foreclosure and mortgagee sales

5.35 The Committee received particularly harrowing descriptions of alleged harsh and oppressive conduct of banks and finance companies in relation to repossession and sales of mortgaged property.

5.36 Issues raised in relation to repossession of property, include:

- failure to inform clients immediately when they are in default on a loan and/or insufficient notice of default to allow clients to refinance before a forced mortgagee sale; [33]
- foreclosure on loans following very small defaults, notwithstanding the small business may be trading successfully and notwithstanding the debt/asset ratio is sound;[34]
- foreclosure when the borrower is not in default, relying on technicalities in loan contracts;[35]
- banks precipitating defaults through the practice of cross collateralisation;[36]

30 *Submissions Nos. 137, 171, 172.*
31 *Submission No. 169.* The bank involved sold its mortgage over a rural property, at a discount, to a $2.00 company over which the bank held a registered charge, allegedly so that the $2.00 company could 'do the dirty work' for the bank.
32 *Submission No. 165.*
33 *Submission No. 171.*
34 *Submission No. 171.*
35 *Submission No. 167.*
36 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*

- inadequate notice provided to owners that their property is to be advertised for sale, to allow them to inform tenants and/or neighbours and to remove possessions from the property;[37]
- negligence in relation to the maintenance of repossessed property and/or damage to plant and equipment and/or running down a business, with a resulting loss when the property/business is sold;[38] and
- refusal to allow clients to sell part (rather than the whole) of their mortgaged property to cover the amount of the default.[39]

5.37 Issues in relation to mortgagee 'fire' sales of property, include:

- inadequate advertising of mortgagee sales or auctions;[40]
- sales below reserve prices, sometimes in suspicious circumstances (including situations where the mortgagee bank provides finance to the purchaser or holds a registered charge over the purchaser);[41] and
- the refusal of banks to allow defaulting clients to purchase back their properties at or above the auction price.[42]

5.38 The forced sale of the property of small businesses effectively puts owners and employees on the unemployment queue. For this reason, the Committee considers that it should not be the immediate result of minor remediable defaults. In 1994, in the middle of the drought, the NSW Government introduced the *Farm Debt Mediation Act 1994 (NSW)* to provide for mandatory mediation between the owner of a farm and any creditor, before that creditor could repossess property or take any other enforcement action under a farm mortgage. The Committee considers this legislation, by its very nature, draws attention to the need for a broad examination of the present law on mortgagee sales to assess whether or not this law can operate to result in harsh and oppressive consequences for small businesses.

5.39 The Committee was urged to recommend amendment of the law relating to repossession and mortgagee sales, to require that:

- financial institutions intending to foreclose be required to prove to a court before they take recovery action that their position is at risk;
- security documentation be public property and standardised in 'plain English'; and
- a dispute resolution mechanism be established to adjudicate in cases where the rights of unsecured creditors and shareholders are jeopardised by the actions of receivers/liquidators.[43]

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37 *Submission No. 171.*

38 For example, *Submission No. 170* tells of how sophisticated computerised manufacturing equipment was repossessed by a bank-owned finance company. The equipment was allegedly dropped five times on its removal from the premises and then left outside in the rain for three weeks. *Submissions Nos. 171 & 172* describe how flourishing rural properties were allowed to fall into disrepair, plant and equipment damaged and livestock maltreated, following repossession.

39 *Submission No. 137.*

40 *Submission No. 132.*

41 *Submissions Nos. 108, 132, 166, 172.*

42 *Submissions No. 137.*

5.40 The Australian Bankers Association (ABA) opposed the first of these proposals, insisting that the ability of a bank to enforce security is fundamental to protecting depositors, and pointing out that the decision to enforce security is often a matter of commercial judgement. The ABA submitted that a requirement that a bank seek the approval of the court to take recovery action:

- would seriously limit the scope for reliance on a security even in the event of a clear breach by a debtor;
- could result in a secured creditor suffering a loss or greater loss on its security through dissipation of assets or deterioration in the financial position of the company;
- could provide a mechanism for a debtor to frustrate or delay the legitimate enforcement of a creditor's right;
- would add costs to the enforcement of securities which ultimately might work to the detriment of unsecured creditors;
- would leave unsecured creditors free to pursue their own remedies against the debtor;
- would place the Court in the position of making a commercial judgement; and
- would undermine certainty of contract.[44]

5.41 The ABA also opposed standardisation of security documentation - nonetheless supporting an improvement to security documentation through 'plain English' redrafting.[45]

5.42 The Treasury submitted that it was aware of allegations that banks had acted prematurely in foreclosing on small business loans, noting however, that when a small business faces financial difficulties, it would be expected that the small business and its bank could have differing views about the prospects of the business in question.[46]

43 *Submission No. 172.*
44 ABA, *Submission No. 34.1.*
45 ABA, *Submission No. 34.1.*
46 Treasury, *Submission No. 168.1.*

5.43 A small business in the air conditioning industry also expressed concern about the behaviour of receivers and liquidators appointed by secured creditors, usually banks, including the practices of:

- 'cashing in' bank accounts of failed companies containing staff entitlements such as long service leave, superannuation, holidays or accumulated sick leave;
- seizing goods and services that had been invoiced to the failed company (but not paid for) for sale at auction or sale back to the suppliers (unsecured creditors);
- negotiating with the debtors of the failed company to yield 'quick cash' rather than fair value to the benefit of secured creditors but to the detriment of unsecured creditors;
- issuing guarantees of payment to specialist suppliers or sub-contractors to complete work in hand with the knowledge that the payments made by receivers can be taken back by liquidators;[47] and
- selling confidential tender information obtained by the failed company (to the detriment of suppliers).[48]

5.44 The same submission was critical of banks for monitoring the affairs of companies in financial trouble with a view to delaying payments to subcontractors and placing companies in receivership immediately after receipt of any progress payments - which include substantial components for payment of suppliers and sub-contractors.

5.45 The ABA submitted that receivers and liquidators are appointed as officers of the courts, accountable to the courts. The ABA noted that the Corporations Law already provides for the settling of disputes over the exercise of power by liquidators and receivers.[49]

5.46 The Committee did not have the time or resources to make a detailed examination of the complex area of receivership and mortgagee sales but considers that the law in this area should be reviewed in light of the serious business conduct issues raised in the Fair Trading inquiry.

5.47 In particular, the Committee considers that it would be worthwhile examining options for allowing for small businesses quickly to establish to the satisfaction of banks that they will be able to meet their financial commitments prior to repossession of their productive and personal assets. The NSW Farm Debt Mediation Scheme provides one possible model of low-level intervention in the enforcement of securities.

47 Air Con Serve Pty Ltd, *Submission No. 14.* The submission points out that receivers follow the practice of giving guarantees of payment to unsecured creditors as a matter of course, knowing that liquidators will recoup the monies - a blatant deception.

48 Air Con Serve Pty Ltd, *Submission No. 14.*

49 ABA, *Submission No. 34.1.*

5.48 Recommendation 5.2

The Committee recommends that, in the light of the business conduct issues raised in the Fair Trading inquiry, the Commonwealth, in conjunction with State and Territory governments, examine the laws dealing with repossession and mortgagee sales with a view to providing that:

(a) property owners have a reasonable opportunity to retire their debts by refinancing, before properties can be sold;

(b) properties sold by mortgagee sale cannot be sold to the mortgagee or any company in which the mortgagee has an interest; and

(c) there is a formal dispute resolution mechanism to guard the rights of unsecured creditors and shareholders against the actions of receivers/liquidators.

Client confidentiality

5.49 A further business conduct issue brought to the attention of the Committee related to the failure of banks and other financial institutions to maintain client confidentiality. In the context of small business banking, damaging information about a client conveyed to suppliers or customers can be ruinous.

5.50 The Committee heard evidence of financial institutions 'warning' clients' creditors and/or encouraging their clients' creditors to sue for bankruptcy, apparently in breach of client confidentiality.[50] The Committee was told of one case where a bank had advised a government authority not to extend drought assistance to a client on the basis that the client's rural enterprise would not be viable in the long term.[51]

5.51 The Committee considers breaches of client confidentiality by banks, occasioning serious commercial damage to small businesses, are a very serious business conduct issue. The Wallis inquiry considered in some detail the need to balance credit reporting requirements (especially for small businesses) with privacy considerations and recommended, inter alia, the establishment of a working party on positive credit reporting.[52]

5.52 Recommendation 5.3

The Committee recommends that the concerns about client confidentiality raised in the Fair Trading inquiry be taken into account by any Taskforce established to review credit reporting and/or privacy of financial records.

50 *Submissions Nos. 108 & 171.*
51 *Submission No. 171.*
52 *Financial System Inquiry Final Report,* pp. 517-24. Recommendation 99.

Handling of disputes

5.53 When problems arise in the area of small business finance, small businesses often have no recourse except to costly legal action. Problems encountered by small businesses in disputes with banks include:

- charging of interest, or penalty rates of interest, when the client is in dispute with the bank about the calculation of the outstanding balance on the account;
- alleged tampering with bank documentation to rectify mistakes made by bank officers;[53] and
- bank exploitation of superior ability to engage the best legal advisers and to prolong a court case until the small business cannot afford to continue.

5.54 The Australians for Banking Justice Association called for 'the establishment of an independent body to hear, judge and determine claims of commercial customers, without the need to use the highly expensive and generally inaccessible legal system'.[54]

5.55 The Association submitted that most Australians cannot afford to take legal action and that the legal system is 'commercially intolerant of small business':

> *... most [bank] customers ... find they can ill afford the unanticipated costs incurred [in litigation]. This is very apparent when a customer wins a claim and then must fund an appeal by the bank. So a customer can lose even if he wins.*[55]

5.56 It was suggested to the Committee that the Banking Ombudsman Scheme be extended to cover small business disputes.[56] The Committee returns to this issue later in this chapter.

Security for small business finance

5.57 Submissions to the Fair Trading inquiry on disputes with financial institutions made it clear that it is common practice to secure small business loans against the real property of borrowers - sometimes commercial real estate but more usually the homes of the borrowers and their guarantors (usually family members).

53 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*
54 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*
55 Marsha Wajnsztajn, Australians for Banking Justice Association, *Submission No. 160.*
56 *Submission No. 101.*

5.58 One of the commercial implications of this practice is that small businesses which are trading successfully can appear to be 'risky' propositions from the point of view of financial institutions if the asset backing of loans falls due to property revaluation, over which the small business has no control.

5.59 One of the social implications of securing business loans against personal assets is that, simultaneously with their coming to terms with business failure, borrowers are customarily evicted from their homes.

5.60 Borrowers may choose to offer the family home as security for a business loan to minimise the rate of interest applying to the loan. This is not a business conduct issue. However, the evidence given to the Committee is not consistent with borrowers being offered a choice.

5.61 In all cases drawn to the attention of the Committee, small business loans were secured against real property and borrowers were pressured to sign over more security to underpin existing loan facilities in times of economic downturn. The Wallis report confirms that the majority of small business finance is provided in the form of secured bank loans.[57]

5.62 The Committee is concerned that Australian banks appear not to be participating to any extent in the risk of small business ventures. Loans to small businesses are heavily secured against assets, minimising the risk to the banks and making it attractive for banks to terminate a small business banking relationship if there is even a minor default on a loan. The Committee took evidence that suggested that some accounts managers looked upon clients' properties as an investment portfolio - to be liquidated at an opportune time - rather than as security in the event of business failure.

5.63 This is not a new issue. This Committee drew attention to the problem during its 1990 inquiry into small business, concluding :

> *Many witnesses argued that banks in Australia placed too much emphasis on the need for collateral security for loans. Banks did not appear to take full account of business plans which indicated the viability of businesses and their capacity to meet debt repayments out of cash flow.*[58]

57 More than half the finance provided to small and medium size enterprises in Australia is in the form of secured bank loans according to a 1995 survey of 1100 SMEs which showed that 53% of respondents had relied on a secured bank loan for capital in the previous two years, the next most important source of capital being personal funds. *Financial System Inquiry Final Report*, p. 444.

58 House of Representatives Standing Committee on Industry, Science and Technology, *Small business in Australia: Challenges, Problems and Opportunities* (January 1990), p. 198.

5.64 The ABA had assured the Committee in the course of the 1990 inquiry that banks were increasingly considering cashflow prospects and business plans when evaluating loan requests.[59] However, the 1997 Wallis report disclosed no evidence of such a trend.

5.65 The Treasury advised that lending to small and medium size enterprises (SMEs) is, by its nature, a risky market and that collateral or security based lending would continue to be important in this sector. However, the Treasury also observed that lending against the cash generating assets of a business (such as receivables, inventory, plant and equipment, intellectual assets) was on the increase.[60]

5.66 The Committee did not have the resources to examine this issue in detail again during the Fair Trading inquiry. The Committee considers the Treasury should examine the implications of lending against assets - rather than against the commercial viability of a small enterprise - for the successful operation of small business in Australia.

5.67 Recommendation 5.4

The Committee recommends that the Treasury, in light of the concerns expressed in the Fair Trading inquiry, examine:

(a) the practice of banks and other financial institutions securing business finance against real property rather than against the commercial viability of the business;

(b) the implications of this practice for the efficient operation and survival of small businesses in Australia;

(c) whether or not banks and financial institutions are charging excessive risk premiums for business finance given that business loans are secured against assets; and

(d) options for promoting or ensuring small business access to finance secured against the potential commercial viability of the business.

59 *Small Business in Australia*, p. 198.

60 The Treasury noted that the Commonwealth Bank's 'Business Assets Finance' product - secured against the income generating prospects of business and its business assets - had attracted $1.3 billion worth of applications since July 1996. *Submission No. 168.1*.

Existing legislative protection

5.68 The ABA advised the Committee on the existing legislative protection for small business borrowers concerned about unfair business conduct. These include:

- the common law equitable doctrines of economic duress and undue influence;
- section 51AA of the Trade Practices Act (Unconscionable conduct); and
- section 52 of the Trade Practices Act (Misleading and deceptive conduct). [61]

5.69 The ABA considers that the existing legislative protections are adequate and opposes any change to the law on unconscionability.[62] However, the ABA did not oppose non-legislative industry-specific solutions to the problems identified by small businesses.[63]

5.70 The Australia and New Zealand Banking Group Limited (ANZ) also opposed any changes to the law on unconscionability. ANZ considers that industry-specific codes of conduct, addressing specific problems in an industry, would be preferable to enacting stronger general purpose legislation.

5.71 ANZ had particular concerns about the Better Business Conduct Bill, claiming the Bill could have a deleterious effect on small business. The bank argued that, in seeking to provide special protection for vulnerable clients, such legislation would have the effect of discouraging banks from negotiating with vulnerable clients at all. The bank submitted:

> *We foresee real problems in agreeing to renegotiate a contract with a customer in financial difficulties, where the customer's range of choice is narrow and it would be perceived that the bank is in a dominant position: there would be little point in entering into renegotiations if it would lead to more litigation under the proposed amendment.* [64]

5.72 The Committee discusses the arguments for and against strengthening the general protection afforded to small businesses under Part IVA of the Trade Practices Act in Chapter 6.

5.73 The Committee considers, however, that strengthening the Trade Practices Act will not, by itself, be an adequate response to the problems encountered by small business borrowers.

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61 ABA, *Submission No. 34.* Fair Trading legislation in States and Territories mirrors provisions in the Trade Practices Act dealing with misleading conduct.

62 ABA, *Submission No. 34.*

63 Ian Gilbert, representing the ABA, *Transcript of evidence,* p. 206.

64 ANZ, *Submission No.* 73.

5.74 As the ACCC pointed out, stronger legislative provisions will only help small businesses to win compensation once all the damage is done.[65] Clearly, it would be preferable to provide for effective dispute resolution when problems arise and before small businesses have lost all their assets and goodwill.

5.75 Moreover, submissions to the Fair Trading inquiry had, as a constant theme, the frustration felt by small business when banks and finance companies exploit their superior access to legal services in disputes. The perception exists that the banks' attitude to dispute resolution is: 'We'll see you in Court, take it or leave it'.[66]

Options for change

5.76 Earlier in this chapter, the Committee recommended small businesses should be included in whatever new regulatory framework emerges from the Wallis inquiry in the area of client protection. The Committee also endorsed the recommendation of the Wallis inquiry that industry dispute resolution schemes be extended to small businesses.

5.77 The Committee was particularly concerned that the dispute resolution scheme operated by the banking industry be extended to small businesses, in light of the findings in the Wallis report that banks are the most significant providers of small business finance.[67]

Code of Banking Practice and the Australian Banking Industry Ombudsman

5.78 Since November 1993, the banking industry has operated under a voluntary code of practice governing all aspects of a bank's relationships with its private retail customers.[68] Since November 1996, standards of conduct relating to loans have been underpinned by the Consumer Credit Code.

5.79 The Code of Banking Practice governs many aspects of the relationship between a bank and its clients including:

- disclosure requirements in relation to the terms and conditions of banking services, including details of fees and charges and details of how interest will be calculated and credited or debited to the account;
- principles of conduct in relation to pre-contractual negotiations and the opening of accounts;

65 Allan Asher, ACCC, *Transcript of evidence,* p. 375.

66 *Submission No. 165.*

67 *Financial System Inquiry Final Report,* p. 443.

68 The provisions of the Code of Banking Practice apply to 'customers'. The Code defines a 'customer' to mean 'an individual, when that individual, whether alone or jointly with another individual, acquires a Banking Service which is wholly and exclusively for his or her private or domestic use ...'. The ABA advised that the Code would not extend to most small business complaints - and certainly not to complaints from incorporated small businesses. Ian Gilbert, ABA, *Transcript of evidence,* p. 214.

- the bank's duty of confidentiality to a client, and the client's right to privacy;
- provisions limiting guarantees and protecting guarantors; and
- dispute resolution outside the courts (incorporating the Australian Banking Industry Ombudsman Scheme).

5.80 It was apparent to the Committee that, if the Code of Banking Practice had applied to small business commercial transactions, most of the matters raised in submissions to the Fair Trading inquiry concerning small business finance either would not have occurred in the first place or, at the very least, might have been resolved more efficiently and at far lower cost to the bank client.

5.81 The 1991 report to Parliament of the House of Representatives Standing Committee on Finance and Public Administration, which provided the impetus for the promulgation of a code of banking practice,[69] recommended that the Australian Banking Industry Ombudsman Scheme should increase the monetary threshold for disputes and should remove the exclusions relating to small proprietary companies.[70] The Wallis report also called for the extension of the scheme.[71]

5.82 The Committee considers there is no sound basis for the distinction between private retail customers and small business customers in terms of the rules of fair dealing by the banks. The Committee considers small businesses - who cannot reasonably be expected to comprehend the complexities of financial documentation and who cannot afford costly legal advice - are entitled to protection in their dealings with banks. The Committee considers the Code of Banking Practice simply sets out principles of fair conduct that could be expected to prevail in all banker/client relationships.

5.83 The Committee believes the Code of Banking Practice (and the Australian Banking Industry Ombudsman Scheme) should cover small business transactions. This would require the removal of any distinction between 'private retail' and 'incorporated commercial' customers, and an increase in the monetary limit on disputes - to at least $500 000, to cover the financial requirements of small business.[72]

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69 House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (AGPS, November 1991), Recommendation 76.

70 House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation*, Recommendation 79. The Australian Banking Industry Ombudsman Scheme commenced in June 1990 and was an initiative of the banks, modelled on a comparable scheme operating in the United Kingdom.

71 *Financial System Inquiry Final Report*, Recommendation 26.

72 The Wallis report, relying on the 1995 *Yellow Pages* survey, noted that more than 90% of small to medium sized businesses seek loans of less than $500,000. *Financial System Inquiry Final Report*, p. 510.

5.84 If the banking community is not prepared to countenance such an extension, then the Committee considers it is time for the Commonwealth to consider the establishment of a mandatory scheme.[73]

5.85 Recommendation 5.5

The Committee recommends that:

(a) the Code of Banking Practice be extended to cover all small business transactions instead of just applying to banking services 'for private or domestic use';

(b) the Australian Banking Ombudsman Scheme be extended to all small businesses, not just those which are unincorporated;

(c) the monetary limit for disputes under the Australian Banking Ombudsman Scheme be extended to $500 000 to encompass the loan requirements of small businesses in Australia; and

(d) if the banks are not prepared to implement part (a) of this recommendation by 30 June 1998, the Commonwealth introduce a code of conduct for the financial sector underpinned in legislation.

73 House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation*, Recommendation 80.