SEMINAR PAPER PRESENTED TO CASHFLOW FINANCE AUSTRALIA

RECENT INSOLVENCY REFORMS AND REGULATORY TRENDS

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Introduction

The purpose of this paper is to round out our series of training sessions by addressing some of the areas for reform in the insolvency and finance related space.

Major reforms in the past 12 months such as the Safe Harbour and Ipso Facto regime were dealt with in an earlier presentation and accordingly will not be addressed in this paper.

The paper addresses:

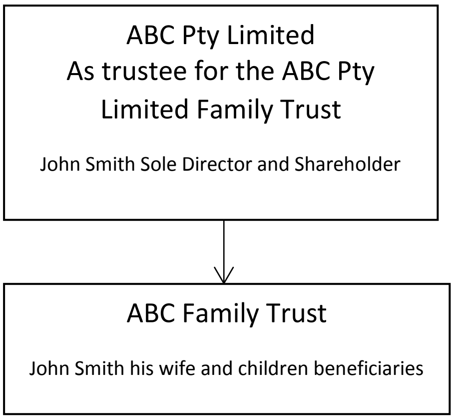
- Corporate insolvency reform including trading trusts and phoenix activity;
- Personal insolvency law reform;
- PPSA reform;
- Significant ATO reform in the insolvency space noting the ATO is also at the forefront of anti-phoenix regulation; and
- Insolvency Statistics

We will also engage in a bit of crystal ball gazing to provide our thoughts with respect to the regulatory implications for the non-bank financial sector arising out of the ongoing Banking Royal Commission.

CORPORATE INSOLVENCY REFORM

Trading Trusts

In a **Trading** trust scenario a corporate trustee acts as trustee of the discretionary trust, with generally the directors of the corporate trustee and their immediate family being the beneficiaries of the trust. This is depicted below: -



Company acts as Trustee only.
Legal title of assets is with the Company.
Beneficial ownership is with the beneficiaries of the trust.

Sole asset of the Company is the right to be indemnified out of the trust assets.

- The trustee company typically has no assets other than paid up capital;
- The trustee is personally liable to creditors for debts incurred in carrying on the business on behalf of the trust;
- If a trustee fails to pay a debt incurred as above, the debt can be pursued and the company wound up;
- Creditors may only claim against the trustee and not the trust assets held by the trustee, the beneficiaries or the settlor of the trust;

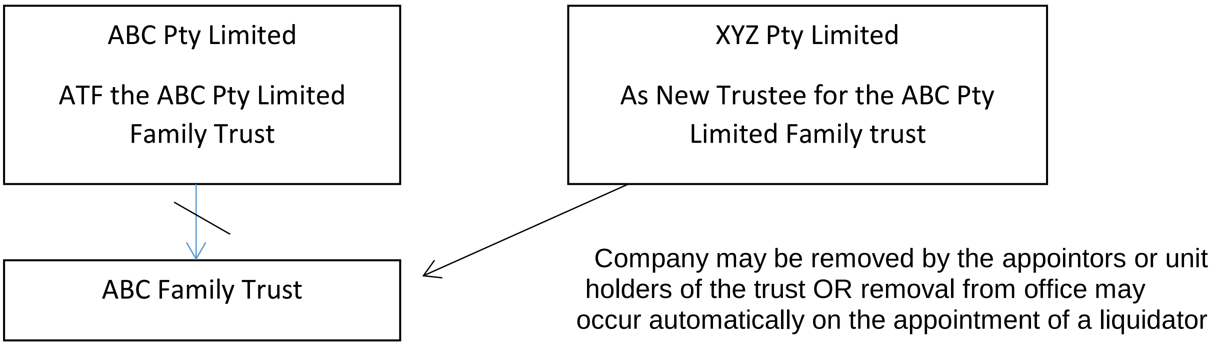
- The property held in trust by the company retains its character as trust property upon the appointment of a liquidator [1]

On a balance sheet the following will be present:-

- The assets of the trustee are any that are owned in its own right and the trustee's right of indemnity (the value of the right of indemnity will be the trust's assets less any secured claims);

- the liabilities of the trust are incurred by the trustee personally and will be recorded as liabilities;

As such the only real asset available to a Liquidator is the right of indemnity, however this may not include the right to sell the assets upon Liquidation of the trustee as the Trust Deed may remove the trustee automatically once the Trustee is placed into Liquidation.



1. Vagrand Pty Limited (In Liquidation) v Fielding (1993) 41 FCR 550 at 522-553

The different scenarios that a Liquidator may deal with upon appointment of a corporate trustee are as follows: -

<u>Company remains Trustee</u>

If a corporate trustee is wound up the company's assets remain vested in the company, including any assets it holds on trust. Unless the Trust deed indicates otherwise, the company in Liquidation will remain as the trustee of the trust and the Liquidator will have both the power and the duty to take control of the trust's assets and deal with those trust assets on behalf of the trustee company. The trustee company is indemnified (and now the Liquidator) out of those trust assets. It is the right of indemnity which will be called upon to discharge the claims of creditors.

<u>Company removed as Trustee</u>

A Trust Deed may provide for the removal of the trustee from the office at any time, upon the winding up either by the appointors or unit holders may exercise this right, or alternatively the Trust Deed may contain an *ipso facto* clause which will result in the automatic removal of the trustee upon insolvency. A Court would also be minded to grant the removal of an insolvent Trustee upon application of a beneficiary or other relevant party. As depicted above the Liquidator of the former Trustee company would only hold the right of indemnity and not control of the assets.

If an automatic removal of the trustee occurs, as indicated above, this would result in what is known as a 'bare' trust. Therefore the trustee ceases to be trustee, the Trust deed no longer applies and the powers provided to the trustee are automatically withdrawn. The company becomes 'bare' trustee and holds the assets on trust, but the powers are limited to preserving and protecting the assets, not selling.

<u>Replacement of Trustee prior to Liquidation and transfer of assets to new trustee</u>

The former trustee has a lien claim over the trust assets for unpaid debts. This lien claim can be asserted by the former trustee (now Liquidator) against the new trustee in respect of the amount of debt incurred by the trustee on behalf of the trust.

In the situation where an ‘uncooperative’ new trustee declines to exercise the power to realise trust property, the former trustee could apply for orders permitting the former trustee to exercise those powers by way of subrogation or alternatively for an order appointing a receiver or receiver and manager over the trust assets.

<u>Trustee removed from office and no trustee appointed or trustee retains assets</u>

Where the trust assets have been retained, a Liquidator would have the following options: -

- Appoint a new trustee under the powers in the trust deed or seek order for the appointment of a new trustee to realise the assets (this may be difficult considering the trust is insolvent);
- Transfer the property to a new trustee and take action if new trustee doesn’t realise trust assets;
- Seek an order appointing a receiver or receiver and manager over the trust assets;
- Seek orders for a judicial sale;
- Retain property as against former trustee (if any) and sell trust property under Section 477(2)(c) of the Corporations Act 2001.

<u>Appointment of a Receiver or Receiver and Manager</u>

A former trustee, where a new trustee has been appointed or a vacancy exists can apply to the Court to be appointed as receiver or receiver and manager over the trust property, which would give rise to the powers under Section 420 of the Corporations Act 2001. For the Court to grant such an appointment it must be just or convenient, i.e. the director(s) of the trustee company would not provide the liquidator with a RATA (an asset and liability position of the company), where the nature of the trust arrangements were not clear and it was necessary to protect the trust property. There is also no authority to suggest that a conflict exists where the liquidator of the corporate trustee also acts as receiver or receiver and manager of the trust property.

Power of Sale

There are conflicting authorities on whether a Liquidator upon appointment to a corporate trustee retains the right to sell trust property, separate from the right of indemnity.

Apostolou v VA Corporation of Australia Pty Limited [2010] [Federal Court of Australia 64]

In this case the applicants claimed to have replaced the company as trustee prior to the liquidation.

The Court determined that Section 477 of the Corporations Act 2001, which provides the powers of a Liquidator (which includes *sell or otherwise dispose of, in any manner, all or any part of the property of the company*) allows a Liquidator to sell trust property, as long as it is subject to the trustee’s right of indemnity.

Caterpillar Financial Australia Ltd v Ovens Nominees Pty Limited [2011] [Federal Court of Australia]

In this case the company ceased as trustee of the trust upon liquidation in accordance with the trust deed. No replacement trustee was appointed.

The Court held that: -

- The company held the assets as bare trustee;
- The company as trustee retained its right of indemnity over the trust assets but no longer had the power of sale. Its duties were limited to preserving and protecting the trust assets;

- The Court considered it necessary to grant the power of sale (pursuant to an application made under Section 479(3) of the Corporations Act 2001 (*the liquidator may apply to the Court for directions in relation to any particular matter arising under the winding up);*

- Whilst the liquidator had sold an asset for value prior to becoming aware of the issues with respect to the trust deed, the Court excused the liquidator for any breaches, failures or omissions and the sale was deemed part of the power of sale granted.

There are two additional cases where the decision above was upheld, **Suncoast Restoration Pty Limited (In Liquidation) & Ors** and **Theobald**. In both scenario's the assets were sold prior to seeking orders granting the power of sale. In all three of these cases, Apostolou and Section 477(2)(c) was not considered.

Southwest Kitchens (WA) Pty Limited [2014] Federal Court of Australia 670

In this case the trust deed disqualified the trustee from acting as trustee upon it being placed into Liquidation.

The Court reconciled Apostolou and the following three cases. The commonality amongst them suggests as follows: -

- A trustee has a right to be indemnified out of trust assets for amounts incurred and a right of release from liability and the trustee is entitled to the benefit of an equitable lien over the trust assets as a means of securing its right of indemnity;

- A liquidator acquires the same rights of indemnity and release as the trustee upon appointment;

- The trustee generally retains the right of indemnity and release despite removal from office;

- The equitable lien securing the trustee's right of indemnity and release does not give the former trustee a power of sale, it is a security which is enforceable by the trustee via a judicial sale or appointment of a receiver or receiver and manager.

The doubt created by the respective decisions was whether the liquidator has a statutory power of sale pursuant to Section 477(2)(c) of the Corporations Act 2001 or whether only the Court can grant the liquidator the power of sale.

Stansfield DIY Wealth Pty Limited (in Liquidation) [October 2014] [NSW Supreme Court 1484, Brereton J]

This case seeks to clarify the difference between a trustee and a bare trustee.

In a case where the company is still the trustee, where the company has not been replaced or automatically removed as a result of the winding up, the Court held that: -

- The trustee's powers remain those that are provided for in the trust deed, therefore the liquidator would be entitled to sell the trust assets and collect in the proceeds;
- If the company was solely trustee of the trust (it did nothing else) the liquidator is entitled to be remunerated for all his/her work;
- If the company conducted other business, the liquidator is only entitled to so much of his/her remuneration (from trust assets) which relate to dealing with the trust and its assets.

In a case where the company has been removed or replaced as trustee the Court held that: -

- There is no such power of sale of trust property without a Court order;
- Section 477(2)(c) does not provide for the power of sale of trust property on the basis that the company as trustee does not beneficially own trust property for the purposes of Section 477(2)(c);
- If the liquidator had a right of indemnity, then that is all the liquidator would be entitled to sell, the right of indemnity and the lien over trust property;

That does not mean the liquidator of a corporate trustee which is removed and replaced is without remedy. One established course of action available to a liquidator in those circumstances is to seek the appointment as a receiver of the trust assets, by way of enforcement of the lien over those assets of the company as former trustee for liabilities incurred by it in that capacity.

Summary

The approach of the Federal Court and the NSW Supreme Court were clearly inconsistent. Without a High Court decision settling the issue liquidators will be required to address the uncertainty when dealing with trust assets.

The prudent course of action would be: -

1. As trustee of a trust, a liquidator is permitted to sell trust property;

2. As a former trustee, a liquidator does not have the right to sell trust property, one could rely on Section 477(2)(c), however this section does not specifically refer to trust property as being part of or not part of the property of the company to which a liquidator can sell. Therefore a liquidator's conduct may be subject to review if this section is relied upon

3. A liquidator should seek order for the power of sale or an appointment as receiver or receiver and manager over the trust property, so as to avoid point 2;

4. If a liquidator was to inadvertently sell trust property prior to realising that they had been removed or replaced, an order should be sought from the court ratifying the sale and excusing the liquidator from any liability for breach of trust.

Conclusion

In the case of compulsory appointments, such as official liquidations a practice has been adopted wherein a winding up order is obtained as well as a court appointed receiver to trust assets.

However, a significant number of liquidations are by way of voluntary appointment either through the mechanism of voluntary administration or directly by way of a creditor's voluntary liquidation. On this basis voluntary administrators of corporate trading trusts, would have to make an application on appointment to secure a power of sale to continue trading.

The intention behind the voluntary administration provisions was to minimise the involvement of the court in the corporate restructuring process and thus reduce costs and enhance the prospects of recovery and a return to creditors. It does seem anomalous that creditors should have to foot the bill, to access trust assets where in practical terms at least it is often those assets which were utilised to secure the creditors original supply. The uncertainty and additional cost burden created by the divergent authorities may require legislative intervention.

An approach that can be utilised in the case of voluntary appointments, is to have the trust deed amended by the trust appointors prior to the appointment to withdraw the removal of trustee clause.

The Ipso Facto reform may also potentially be relied on with respect to trust deeds dated post 1 July 2018. As the Ipso Facto reform is not retrospective the position with respect to trusts established prior to that date is to either:

1) Remove the Ipso Facto clause pre appointment to a trading trust; or

2) Seek judicial power of sale.

From the perspective of financiers some precautions can be taken at the outset of the credit relationship at the application stage to address the existence of trust structures.

- Applicants should be compelled to identify whether trading assets are held in their own right or beneficially on trust;

- Security interests over property held on trust should be taken;

- Personal guarantees should be drafted so as to include property held by the guarantor on trust.

Priorities

Independent Contractor Services (Aust) Pty Limited ACN 119 186 971 (in Liquidation) (No 2) [2016] NSWSC 106

In this case the company was solely a trustee of a trust. As indicated previously, a liquidator is entitled to pay himself/herself reasonable remuneration from the trust assets for all work conducted in winding up the company.

Had the company undertaken other roles, the liquidator would only be entitled to recoup from the trust assets the work conducted in relation to the trust and its assets.

As indicated above the Liquidator sought approval for remuneration from the Court as a liquidator cannot seek a resolution for approval from creditors under Section 473 and 499 of the Corporations Act 2001 as these methods relate to property of the company.

This case also suggested that the priorities under Section 556 do not apply when distributing trust property. All of the trusts unsecured creditors are treated equally (pari passu) including employee entitlements and superannuation.

The priorities to be followed as indicated in Independent Contractor Services (Aust) Pty Limited ACN 119 186 971 (in Liquidation) (No 2) [2016] NSWSC 106 when dealing with trust property were fully explored in the decision of *Re Amerind (receivers and managers apptd)(in liq)* [2017] VSC 127; (2017) 320 FLR 118.

<u>Background</u>

- Amerind acted solely in its capacity as trustee of a trading trust
- Amerind had no real assets of its own.
- Amerind incurred liabilities in acting as trustee
- All creditors were trust creditors
- Amerind had no funds of its own to discharge the liabilities incurred
- Amerind sought to be indemnified from trust assets to pay for liabilities incurred in carrying out its role as trustee of the trust
- There was a shortfall of liabilities incurred against trust assets
- The Commonwealth had advanced funds totalling $3.8million to fund employee entitlements under the Fair Entitlement Guarantee (“FEG”) Scheme.
- The Receivers after discharge of the secured creditor and their own remuneration had a surplus of approximately $1.6 million

<u>Issue</u>

How was the surplus to be distributed?

The following sections of the Corporations Act 2001 deal with priorities.

Section 433

This section, means that debtors or stock (circulating assets) must be used to discharge employee entitlements like wages, superannuation, annual leave and redundancy, prior to discharging any secured interest over these assets of the Company.

This does not relate to debtors where a financier has taken an assignment of those debtors and therefore they are no longer treated as assets of the Company.

Section 560

This section states that any party who has advanced funds in respect of the payment of wages, superannuation, annual leave and redundancy, subrogates to the priority position of the employees and can claim the same priority as they would have otherwise have had if they were still owed these entitlements upon any external administration of the company.

Section 556

States that employee entitlements including wages, superannuation, annual leave, redundancy, etc receive a priority above unsecured creditors in a winding up scenario.

Therefore, if the priorities of Section 556 are ignored in a trust scenario then all creditors are unsecured creditors and are treated equally and there is no priority afforded to employees and Section 560 would confer no particular priority on those who provide advances for employee entitlements such as FEG.

Furthermore, if trust assets are not considered circulating assets then Section 433 is not considered either when distributing the surplus.

The Receivers sought directions.

<u>Decision</u>

Their Honours on the *Amerind* appeal held that –

- A corporate trustee's right of indemnity from trust assets is property of the trustee company within the meaning of Section 433 of the Corporations Act. not property of the trust, as was originally held. Therefore, a priority to employees and the Commonwealth for payments made in respect of employee entitlements are provided for in relation to circulating assets.

- The statutory scheme of priority applies to distribution of the relevant property, being the receivership surplus subject to the right of indemnity. This had the result that the Commonwealth's claim to priority in the distribution of the receivership surplus by virtue of the payments it had made of employee entitlements under FEG was confirmed.

- Certain assets in dispute fell within the meaning of property secured by a 'circulating security interest'. Their Honours held that the relevant assets in this context was not the right of indemnity but the trust assets. The correct date for assessing whether property is subject to a circulating security interest under s 433 is the date the receiver is appointed and takes possession.

The Full Court of The Federal Court in its original jurisdiction in ***[Jones Liquidator in Matrix Partners Pty Ltd, in the matter of Killarnee Civil and Concrete Contractors "(Killarnee)"]*** accepted that whether because of the statutory priorities regime and/or equity, liquidators costs and remuneration and employee entitlements will likely be afforded a priority over claims of other creditors to funds realised through distribution of trust property.

However the law in this area is not completely settled as an application was made in the Amerind litigation for special leave to appeal to the High Court.

A decision in at least one Supreme Court proceedings has been adjourned pending the outcome of the Amerind special leave application. ***MJM (NA) Enterprises Pty Ltd [2014] NSWSC 944***

FEG has established a task force to ensure that insolvency practitioners are paying out proceeds recovered from circulating security interest property in accordance with the aforementioned priorities under the Corporations Act.

The FEG taskforce has been active in respect of practitioners and their secured appointees where they consider the funds ought to have been paid to them for the advances made in respect of employee entitlements.

ASIC Funding

It costs ASIC $10 million per year to regulate the insolvency industry, largely being its practitioners. Therefore it has been decided that the Insolvency Practitioners should fund the cost of that monitoring.

ASIC will be sharing the monitoring cost across all insolvency practitioners, approximately at last count 670, which is known as a cost recovery levy.

The levy to be paid comprises two parts:

1) a minimum levy component – set at $2,500; a graduated levy component (based on specified business activity metrics being a practitioners share of Chapter 5 appointments and 'notifiable events').

2) ASIC has developed a two page fact sheet, available on the ASIC website.

What are entity metrics?

The metrics used to calculate the levy are set out in section 20(3) of *ASIC Supervisory Cost Recovery Levy Regulations 2017*. The leviable entity's entity metric for the subsector for the financial year is the sum of:

a) the number of appointments under Chapter 5 of the Corporations Act 2001 accepted by the entity in the financial year:

   i) an appointment as a controller;

   ii) an appointment as a liquidator;

   iii) an appointment as a managing controller;

   iv) an appointment as a receiver;

   v) an appointment as a receiver and manager;

   vi) an appointment as a scheme manager;

   vii) an appointment as a voluntary administrator;

   viii) an appointment as an administrator of a deed of company arrangement; and

b) the number of appointments of the kind mentioned in subparagraph (a)(i) to (viii) that were accepted in an earlier financial year and that the entity is still acting in at the start of the financial year for which the levy component is to be calculated; and

c) the number of the following events that are published on the publication website maintained by ASIC in the financial year:

   i) notice of meetings;

   ii) notice of disclaimer of property;

   iii) notice to submit particulars of debt or claims;

iv) notice to creditors to submit formal proof;

v) notice of intention to declare dividend; and

d) the number of the following documents lodged with ASIC by the entity in the financial year:

i) a notice of the outcome of a proposal to pass a resolution without a meeting (however, if more than one proposal to pass a resolution without a meeting in relation to the same administration is decided on the same day, count the proposals as a single lodgement);

ii) an executed deed of company arrangement (however, if the deed involves more than one company under external administration, count the deed as a single lodgement).

How are the business activity metrics applied for joint appointees

Where there is more than one appointee to a Chapter 5 appointment, the graduated levy component is determined as follows:

- for the number of Chapter 5 appointments: each appointee includes the appointment in their return; and

- for the number of 'notifiable events': only the registered liquidator publishing the notice or lodging the document with ASIC includes the notifiable event in their return.

When will I receive the levy invoice?

ASIC expects to issue the invoices based on practitioners returns and the calculation of the final subsector cost in January 2019.

When is the levy paid?

The industry funding levy invoice will specify a date to pay the levy.

This date must be no less than 30 days after the invoice is provided (refer section 9 of the *ASIC Supervisory Cost Recovery Levy (Collection) Act 2017*).

What period does the levy cover?

ASIC's industry funding model is an *ex-post* model, meaning it is based on costs from the previous financial year.

The industry funding levy invoice received will be a levy calculated on the activity reported in the individual returns lodged for the preceding financial year and the actual costs incurred by ASIC in regulating the insolvency practitioners subsector that financial year.

For example, the industry funding levy invoice that ASIC will send in January 2019 will be based on activity reported by registered liquidators for the 2017-18 financial year and ASIC's actual regulatory costs allocated to each respective registered liquidator for the 2017-18 financial year.

Is the levy tax deductible?

Yes – the levy is tax deductible.

What will happen if the levy is not paid?

a) if the levy is not paid in full by the due date: a late payment penalty is payable on the amount outstanding for each month; calculated on the outstanding balance of the levy at the start of each month

b) if the levy remains outstanding for more than 12 months after the due date for payment: ASIC may suspend or cancel registration as a liquidator

c) **Is there a waiver from paying the levy?**

d) ASIC may waive all or part of any levy, late payment penalty or shortfall levy if satisfied there are exceptional circumstances justifying the waiver

e) **Will amounts paid for publishing notices on the Published Notices Website be deducted from the levy payable?**

f) Yes, amounts paid for publishing notices on the Published Notices Website for notifiable events will be deducted from the costs to be recovered from the registered liquidator sector.

g) The actual publishing costs you pay are not deducted specifically from the industry funding levy you are liable to pay.

Can the cost of the levy be recovered?

The industry funding levy will become an annual cost of doing business. ASIC recognises the challenges for legal entities in the first year, given that indicative levies (at the subsector level) will not be published until March 2018. However, ASIC will make best efforts to provide registered liquidators with estimates where possible, to facilitate both the on-passing of costs in the financial year that they are incurred and to facilitate business planning.

Phoenix Activity

In our training presentation No.3, we provided information in respect of phoenix activity and referred to a report commissioned by the Fair Work Ombudsman July 2012 titled *"Phoenix Activity – Sizing the Problem and Matching Solutions".* That report identified a range of impacts on the Australian economy including, employees losing entitlements (including superannuation), phoenix companies not paying debts businesses/customers not receiving goods and services paid for and government revenue not being received. The report sought to quantify the total impact of phoenix activity, based on available data, to a range of **$1.78 to $3.19 billion per annum**.

A further report has been commissioned by the ATO, Fair Work Ombudsman and ASIC finalised in June 2018 titled "*The Economic Impacts of Potential Illegal Phoenix Activity"*.

The report states that the direct cost of potential illegal phoenix activity on an annual basis for 2015-2016 is as follows: -

- Business - $1,162 million to $3,171 million in unpaid trade creditors;
- Employees - $31 million to $298 million in unpaid employee entitlements;
- Government - $1,660 million in unpaid taxes and compliance costs

The total direct cost is in the range of $2.55 to $5.13 million

The total impact on the economy is estimated to be in the range of $1.8 to $3.5 billion.

The represents between .11 percent and .21 of real GDP for 2015-2016.

As advised previously tougher penalties and counter-measures such as a Director Identification Number are the heart of the Government's "anti-phoenixing" reforms to deter and disrupt the core behaviours of phoenix operators, including non-directors such as facilitators and advisers, announced on 13 September 2017 by Kelly O'Dwyer.

On 16 August 2018, the Turnbull Government issued the following media release: -

“Legislation to combat illegal phoenix activity released for consultation” .

The media release advises that the then Minister for Revenue and Financial Services, the Hon Kelly O’Dwyer MP released draft legislation to combat illegal phoenix activity. The legislation is intended to *“deter and disrupt the core behaviours of illegal phoenixing and more harshly punish those who engage in and facilitate this illegal activity, including pre-insolvency advisors”.*

The reforms will: -

- *“Create new phoenix offences to target those who engage in and facilitate illegal phoenix transactions;*
    - *It will now be an offence for company directors to engage in creditor-defeating transfers of company assets that prevent, hinder or significantly delay creditors’ access to those assets;*
    - *Pre-insolvency advisors and other facilitators of illegal phoenix activities will also be on the hook, with a separate offence for any person who procures, incites, induces or encourages a company to make creditor-defeating transfers of company assets.*
    - *These will be both criminal and civil offences*
    - *The offences will be supported by an extension of the existing liquidator asset clawback avenues to cover illegal phoenix transactions. ASIC will also receive a new regulatory tool to recover property that has been transferred under an illegal phoenix transaction. This tool will be particularly important where a liquidator is complicit in or turning a blind eye to illegal phoenix activity. These supporting measures will assist in the quick and efficient recovery of property, for the benefit of all employees and creditors.*
- *Prevent directors from backdating their resignations to avoid personal liability;*
- *Prevent sole director from resigning and leaving a company as an empty corporate shell with no directors;*
- *Restrict the voting rights of related creditors of the phoenix company at meetings regarding the appointment or removal and replacement of a liquidator;*
- *Make directors personally liable for GST liabilities, as part of extended director penalty provisions;*
- *Extend the ATO’s power to retain refunds where there are outstanding tax lodgements.*

Submissions in relation to the above reforms will close on 27 September 2018.

<u>PERSONAL INSOLVENCY REFORM</u>

<u>Proposed Bankruptcy Law Changes</u>

Proposed changes to Bankruptcy Law are scheduled to be passed by the Senate this week.

The major change is a reduction of the default period of a bankruptcy from 3 years to 1 year. As part of this change, other relevant time periods will also be reduced to one year as follows:

- Automatic discharge after one year of the bankruptcy to apply to persons who become bankrupt after the commencement of the new law, which would remove certain restrictions on overseas travel, obtaining credit and company board eligibility;

- Bankrupt to notify the trustee within 10 business days of changes to their name, address, and phone number during the ‘prescribed period’;

- The amendments will commence six months after receiving royal assent in order to allow trustees, debtors and creditors to adjust and prepare any objections to discharge.

The changes are intended to promote innovation and entrepreneurship in the Australian economy by allowing debtors to get on with their lives and business endeavours sooner rather than later and without the stigma of bankruptcy.

There is potential for abuse with these changes by rogue debtors, as the changes are intended to assist those who suffered from economic hardship or legitimate business failure not those who simply avoid paying creditors.

It has been proposed that rather than automatic discharge an eligibility criteria be met, some examples of potential criteria are non-lodgement of tax returns for a significant period, significant level of creditors claims including the ATO.

It is also to be queried as to whether, once discharged, bankrupts will still assist a Trustee and comply with their obligations under the Bankruptcy Act 1966, given that the threat of objection to discharge post one year is no longer there. A bankrupt would still be liable for income contributions for 3 years even though they are discharged from bankruptcy.

The changes are retrospective so anyone who is currently bankrupt will automatically be discharged 6 months after the legislation has been passed. As a result AFSA (the personal insolvency regulator) is anticipating an influx of objections to discharge to be lodged by Trustees in the next 6 months.

ATO REFORM

GST withholding regime

The new "GST withholding" regime commenced on 1 July 2018 and it promises to have a significant impact on purchasers and vendors and will require purchasers in particular to be aware of their obligations and be prepared during real property transactions.

This regime applies from 1 July 2018 for new residential property. The regime requires purchasers to directly remit GST to the ATO.

The new legislation does include a transitional arrangement that excludes contracts entered into before 1 July 2018 where any consideration for the supply (other than the deposit) is provided for before 1 July 2020.

Key Features

The GST withholding regime imposes obligations on **both** purchasers and vendors to remit the GST from real property transactions.

GST Withholding on new residential property supplies

The GST withholding applies to taxable supplies as follows: -

- "new residential premises" (other than those created through "substantial renovation" and "commercial residential premises"); and

- certain subdivisions of "potential residential land", where the subdivision does not contain any buildings used for a commercial purpose.

Amount of GST to be withheld

The recipient of the supply (i.e. typically, the purchaser) must withhold and pay to the ATO:

- 1/11th of the "contract price"; or

- 7% of the "contract price" **where the margin scheme applies**.

These are fixed percentages applied to the stated contract price, i.e. settlement adjustments are not taken into account. There is no new requirement for the vendor to disclose the actual amount of GST anticipated to be payable on the supply.

When does the GST need to be remited

The purchaser must remit the GST withholding amount to the ATO on or before the day any of the consideration for the supply is first provided (other than as a deposit) – i.e. on the day of settlement in most instances.

Suppliers obligations

The supplier must notify the purchaser in writing as to whether GST withholding is required before the supply is made. This obligation will apply to **most** supplies of residential premises or potential residential land even where it is clear that the supply will not be taxable (eg. sale of an existing dwelling by a vendor not registered for GST purposes).

Where the supply is subject to GST withholding, the notice must also provide certain specified details – including the GST withholding amount and time for payment.

Penalties on Supplier for failing to notify

A failure by the supplier to notify the purchaser regarding GST withholding is a strict liability offence, with a maximum fine that can be imposed by a court of 100 penalty units (currently, $21,000) for individuals or 500 penalty units (currently, $105,000) for corporations. Alternatively, the ATO may impose an administrative penalty of 100 penalty units ($21,000).

Penalties on Purchaser for failing to withhold

Failure by the purchaser to withhold the GST withholding and remit it to the ATO gives rise to an administrative penalty under existing provisions (equal to 100% of the amount to be withheld). The penalty will not apply if the purchaser has relied on a notification from the supplier (provided reliance is reasonable), or if the purchaser has provided the supplier with a bank cheque for the GST withholding that is payable to the ATO.

Supplier credit for GST withholding

The supplier remains liable for the GST on a taxable supply that is subject to GST withholding, but is entitled to a credit equal to the GST withholding amount remitted to the ATO by the purchaser. Any variation between the GST withholding amount and the supplier's actual GST liability would be corrected in the supplier's Business Activity Statement.

Prior to this reform there were a number of companies whose business it was to sell residential property, who would settle the respective contracts and not remit the GST to the ATO. The GST amount incurred is then not able to be repaid and the Company is then placed into liquidation. This is clearly the ATO's direct response to circumventing that strategy from continuing to happen and is part of their overall illegal phoenix initiatives

Vendors will need to be aware of the notification obligations and Purchasers will need to be aware of their obligation to remit the GST and make appropriate arrangements prior to settlement.
Developers and financiers will also need to be aware of the impact of the regime.

Proposed Superannuation Guarantee Amnesty

This proposal was announced to commence on 24 May 2018 for a 12 month Superannuation Guarantee Amnesty ("SGCA") ending on 23 May 2019. However the amnesty has not been passed into law as of yet:

The SGCA is a one-off opportunity for employers to correct past non-compliance of SGCA without incurring penalties.

If Employers utilise the SGCA and disclose prior unreported SG shortfalls from 1 July 1992 up to 31 March 2018 during the above period and before an audit is conducted on their SGC shortfall, they will: -

- Not be liable for the administration fee (usually $20 per employee per period) and penalties that would have otherwise have applied for late payment;
- Be able to claim a deduction for catch-up payments made in the 12 months period.

Employers will still be required to pay all employee entitlements which includes unpaid SG and interest.

The ATO has stated that those employers who do not come forward during this period and disclose the unreported SGC may face higher penalties in the future.

As a result of the SGCA not being enacted, the old law is still enforced and penalties will still be charged and be payable, there is also currently no deductions on amounts paid in the 12 month period. The administration component will not be required to be paid until the outcome of the legislation is known.

If the law does not come into effect the old law stands, so no amounts will be tax deductible as these amounts were always payable under the law and the administration component will be imposed after the decision is made.

It is curious as to whether the SGCA will have a huge take up from those that have not been reporting their SGC shortfalls given the above uncertainty and lack of benefit until the legislation is enacted.

It is currently unknown as to whether the SGCA extends to the personal liability imposed on directors who fail to report SGC amounts within the required time frame, being within 3 months after the end of the quarter.

As the draft legislation is silent in this respect, it is suspected it will not absolve directors of their exposure for personal liability for failure to lodge within required statutory timeframe.

Transparency of Tax Debts

Last year the Government announced that it will allow the ATO to disclose the debt amount of businesses to registered credit reporting bureaus.

The criteria for reporting a tax debt is as follows:

- The business has an ABN and is not an excluded entity
- The tax debt is over $10,000 and is overdue by more than 90 days; and
- The business has not been 'effectively engaging' with the ATO in order to discharge the tax debt.

The disclosure of these tax debts is intended to assist with decision making when businesses are interacting with one another and to reduce the unfair advantage obtained by those that don't pay their tax debts on time or at all.

'Effectively engaging' will be defined with public consultation, however it is anticipated it will involve either entering into a repayment plan or that there is a dispute regarding the tax debt.

The ATO will notify a business that their tax debt will be reported to a credit bureau if after 21 days from that notice they fail to respond.

We understand:

- The legislation is still to be drafted but may be passed by the end of this year;
- The ATO will likely target large companies, not SMES

This initiative is not surprisingly controversial and that is more than likely the reason for the delay in its implementation, since it was first announced.

PPSA REFORM

The most significant legislative reform to the PPSA addressed the definition of PPS lease. The equipment hire industry were caught up in the regime in order to perfect title in this area as a result of this definition and it became a logistical nightmare to register their fleets.

The equipment hire industry lobbied for change and significant relief was granted.

PPS Lease

Section 13(1) originally provided that:

A PPS lease means a lease or bailment of goods

- For a term of more than one year; or
- For an indefinite term (even if the lease or bailment is determinable by any party within a year of entering into the lease or bailment);
- For a term of up to one year that is automatically renewable or that is renewable at the option of one of the parties, for one or more terms if the total of all the terms might exceed one year; or
- For a term of up to one year, in a case in which the lessee or bailee with the consent of the lessor or bailee retains uninterrupted (or substantially uninterrupted) possession of the leased or bailed property for a period of more than one year after the day the lessee or bailee first acquired possession of the property (but not until the lessee's or bailee's possession extends for more than one year.

In May 2017 the Personal Property Securities Amendment (PPS Leases) Act made two changes to Section 13.

  - The alteration of the reference to more than one year to 'more than ten years'; and
  - An amendment to Section 13(1)(d) which effectively provides that an indefinite lease / bailment only becomes a PPS lease after more than 2 years of substantially uninterrupted possession have expired.

The amendment act does not apply retrospectively i.e. it only applies to leases entered into after 19 May 2017 and accordingly the original definition of PPS lease will be applicable to arrangements entered into prior to that date.

The following examples illustrate this change:

Examples

(a) HireCo and customer enter into hire of a jackhammer for 'as long as you need it'. Now not a PPS lease at inception.

(b) HireCo and customer enter into indefinite hire of jackhammer on 19 May 2017. PPS lease from inception – not covered by the new test under the transitional rules in the amending legislation.

(c) HireCo and customer enter into hire of a jackhammer for 18 months with customer option to extend for a further seven months. This is a PPS lease from inception.

(d) HireCo and customer enter into indefinite hire of jackhammer. Eighteen months into the hire, customer tells HireCo – 'the job I am on is going to last for another year'. HireCo rep says – 'No problem, keep the jackhammer until then.' PPS lease at that time.

Hire business need PMSI "super priority" to defeat banks and other financiers with general security who perfect earlier than they do.

Hires are PMSIs unless they are sale and lease backs.

Accordingly if a lease or hire of goods fits the PPS lease definition it is caught by the PPSA and subject to its priority rules with respect to perfection and registration. Ownership does not allow an escape from the consequences of incorrect or late registration or non-registration.

Reduced Fees

The Personal Property Security Register ("PPSR") fees reduced their fees on 1 August 2018.

Australian Finance Industry Association "(AFIA)" provided guidance to Members on 'in-flight' transactions for consumer finance where PPSR registration and/or search fees are to be explicitly passed on to the consumer. This Notice identifies for Member consideration two approaches to consider, taking into account systems and other operational issues.

One approach would involve an affected Member with a contract document disclosing the current PPSR fee amount either:

- only passing on the reduced fee for registering and/or searching the PPSR, regardless of what is disclosed in the contract; or
- applying the current amount then crediting the consumer's loan account with the difference or otherwise rebating or refunding.

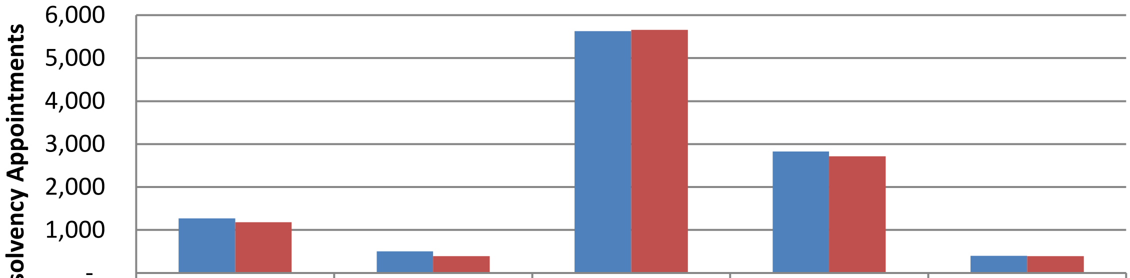
PPSA Approach

Because the Personal Property Securities Act (‘PPSA’) permits registration of a security interest on the PPSR before a security agreement is entered into, an affected Member could have registered on the PPSR in relation to an in-flight transaction before 1 August 2018 at the current fee amount.

To do that requires the affected Member to have a belief on reasonable grounds they will become the secured party. If the transaction does not proceed, the Members must remove the registration: PPSA Section 151.

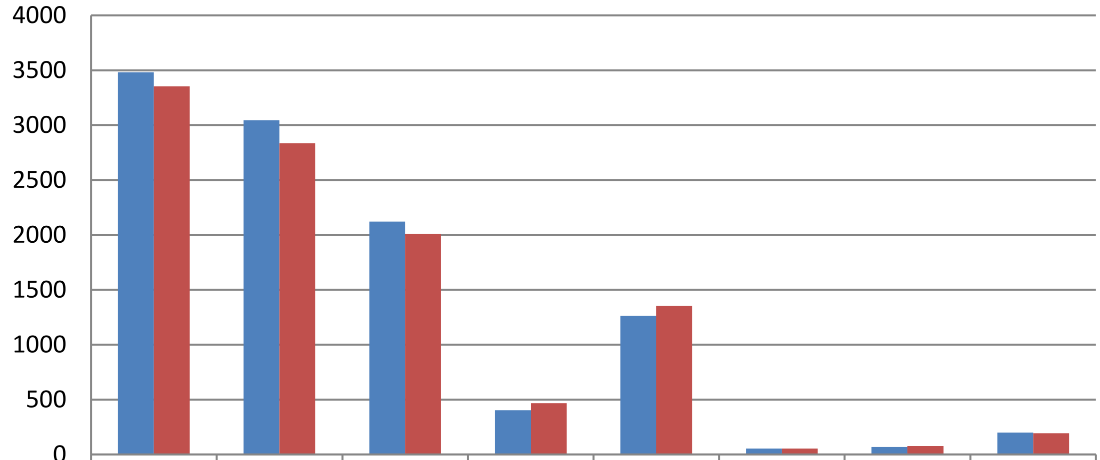
<u>INSOLVENCY STATISTICS</u>

Insolvency Appointments



	Voluntary Administration	Deeds of Company Arrangement	Creditors Voluntary Liquidation	Official Liquidations	Receiverships
FY2017	1,272	505	5,628	2,827	400
FY2018	1,182	395	5,661	2,714	393

Insolvency Appointments by State



	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	3482	3045	2120	402	1263	53	68	199
FY2018	3354	2835	2012	466	1353	53	78	194

- Nationally there was a slight overall reduction in the number of appointments.

- Over half the total number of appointments were by of creditors voluntary winding up.

- This could be indicative of a couple of factors:

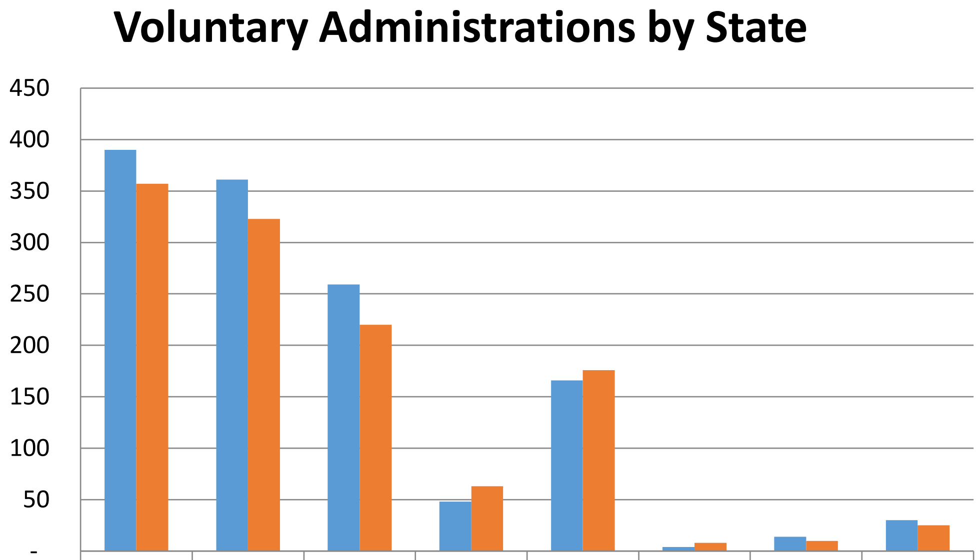
    - It could represent an uptake of CVL’s as a result of law changes which no longer require a creditors meeting to be held.

    - A significant number of these CVL’s would have had limited (if any) assets and/or were not business capable of being restructured.

- There was a significant fall in companies restructured by way of deed of company arrangement and that does lead to a query as to the necessity or likely uptake of restructure by way of the safe harbour mechanism.

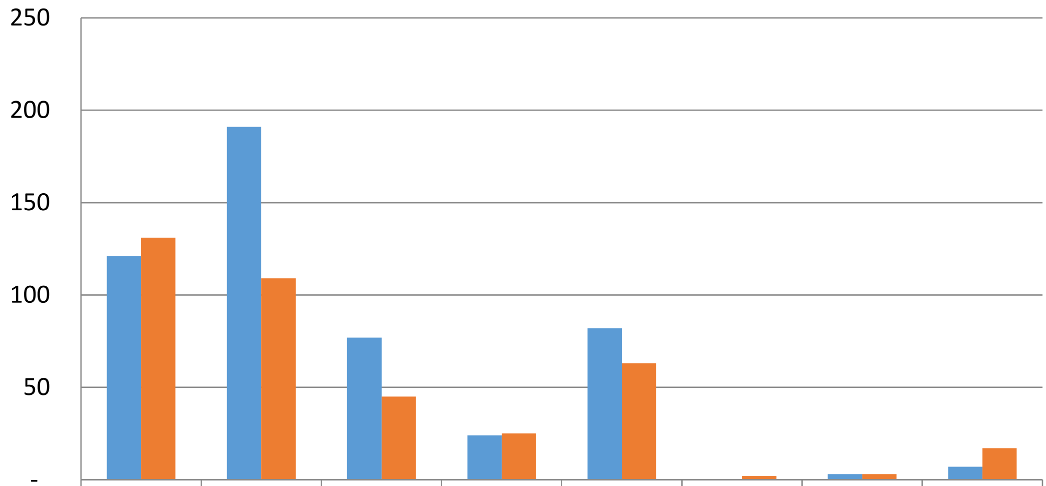
- As always the top line numbers have to be interrogated to identify underlying trends.

Appointments by State



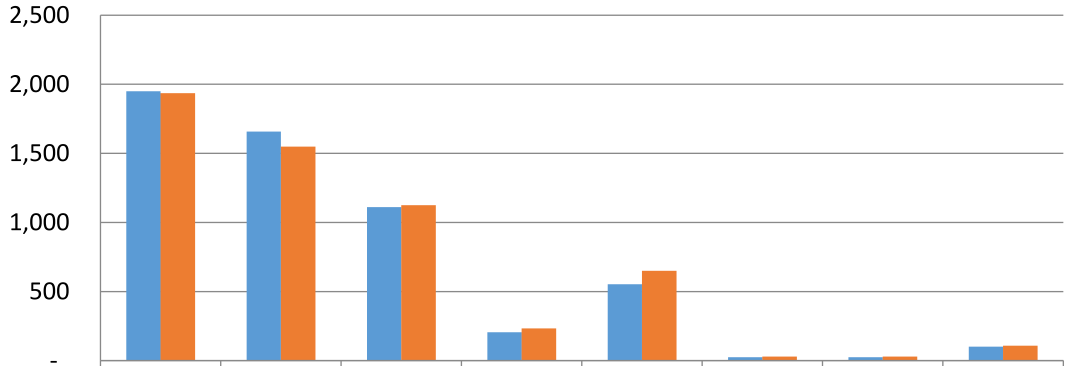
	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	390	361	259	48	166	4	14	30
FY2018	357	323	220	63	176	8	10	25

Deeds of Company Arrangement by State



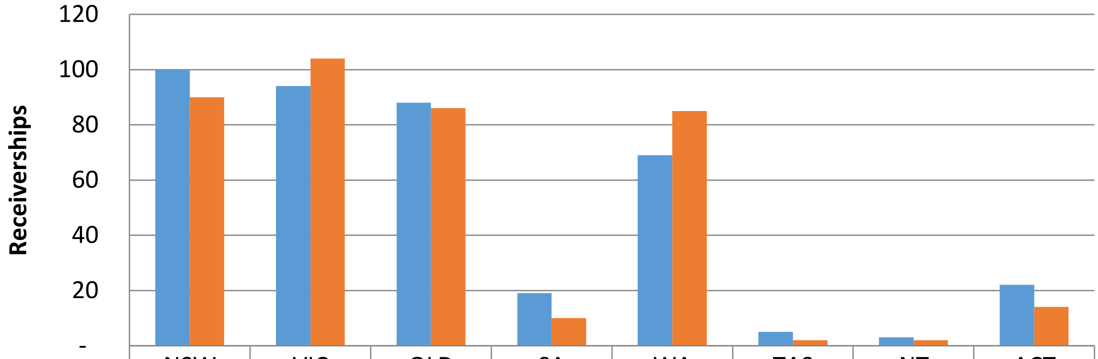
	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	121	191	77	24	82	-	3	7
FY2018	131	109	45	25	63	2	3	17

Creditors Voluntary Liquidations by State



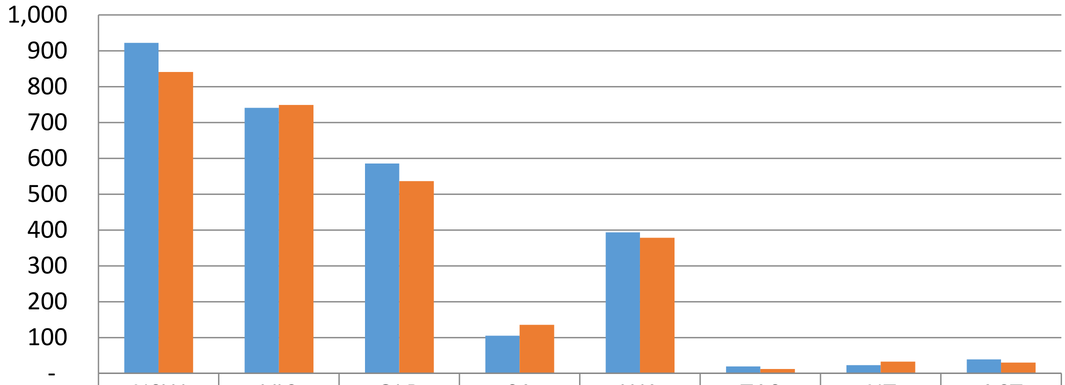
	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	1,949	1,658	1,111	206	553	25	25	101
FY2018	1,935	1,550	1,125	233	651	29	30	108

Receiverships by State



	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	100	94	88	19	69	5	3	22
FY2018	90	104	86	10	85	2	2	14

Official Liquidations by State

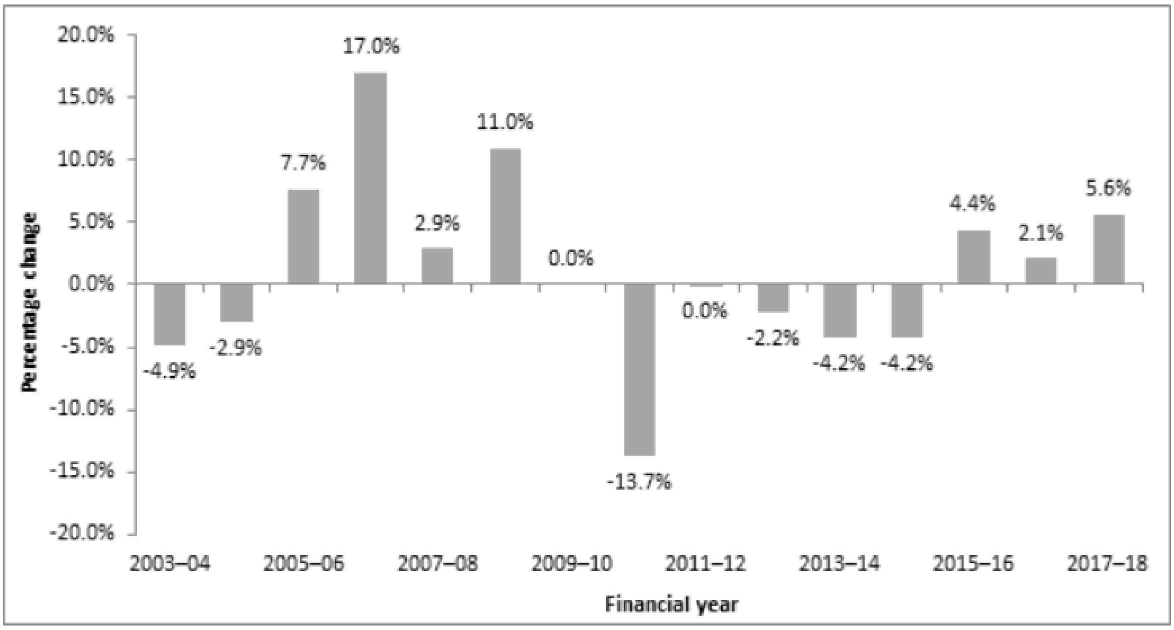


	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
FY2017	922	741	585	105	393	19	23	39
FY2018	841	749	536	135	378	12	33	30

- An analysis on a state by state basis indicates overall falls in appointments across the eastern seaboard from 2017 to 2018.
- WA & SA both experienced significant increases in a number of categories of appointment
- In the case of WA this is reflective of the slowdown of the second resources boom
- As a result of depressed economic conditions SA has been earmarked for a number of significant manufacturing projects supported by the Federal government.

- Surprisingly the level of receiverships remained relatively constant. In fact WA experienced a spike in receiverships. This is despite anecdotal evidence that banks are less likely to appoint in the current regulatory climate. This could be indicative that non-bank lenders continue to make secured appointments as they are less subject to public scrutiny and are subject to liquidity restrictions

Total personal insolvency activity in Australia: % change compared to the previous year



Source Australian Financial Security Authority

- There were 31,859 personal insolvencies in Australia in 2017-2018. This was an increase of 5.6% compared to 2016-2017. Total personal insolvencies have risen for three consecutive years.
- Debt arrangements increased to an annual record of 14,834 in 2017-18 which was a 9.1% increase compared to 2016-2017 and they have reached record levels for six consecutive years.
- Personal insolvencies have increased at a time when corporate insolvencies have been reducing.
- This is indicative that the drivers of personal insolvency are somewhat different to corporate insolvency i.e. in particular current credit debt.
- This does call into question the policy rationale for the proposed reduction in the period of bankruptcy.
- It is also leads to concern about the effect of potential interest rate rises on the rate of personal insolvencies going forward.

REGULATORY TRENDS

Since the GFC, and excluding the current Financial Services Royal Commission there have been over 17 inquiries and reviews undertaken into practices in the financial services sector not including the APRA investigation into the CBA.

Two of the inquiries which dealt with Small Business Loans were:

- Inquiry into Small Business Loans by the Australian Small Business and Family Enterprise Ombudsman “(the Carnell Report)”.

- The independent review of the code of Banking practice “(the Khoury)” Report

It is fair to say the recommendations of these reports could described as sympathetic to banking customers and cut across a number of established practices in the banking customer relationship particularly relating to small business.

However, these reviews received submissions from extreme examples of poor outcomes and as is often the case in industries which find themselves subject to regulatory oversight it is the minority which influences the ultimate outcome for the majority and it is emblematic of an environment wherein the finance community may have little option but to adopt a number of these recommendations or a variant thereof or face the prospect of further regulation being forced upon them.

In summary it’s fair to say the industry faces a sea change and what is perceived as the old way of doing business, particularly as regards to small business will no longer be sufficient.

The Carnell Report

The Carnell Report was produced by the Australian Small Business and Family Enterprise Ombudsman following her investigation into the adequacy of the law and practices governing financial lending to small business and was released on 6 February 2017.

The report made 15 recommendations:

Recommendation 1

The Australian Banker’s Association “(ABA)” six point plan must be strengthened by publishing individual bank implementation plans including key milestones and deliverables. Outcomes against these plans must be published.

In April 2016, the ABA announced its six point plan to address problems raised and test the banking industry’s commitment to implement reform measures.

The plan contains measures designed to protect consumer interests, increase transparency and accountability and build trust and confidence in banking.

Recommendation 2

The revised Code of Banking Practice 2017 be approved and administered by the Australian Securities and Investments Commission under Regulatory Code 183. The Code must be written in plain English and include a dedicated section on small business clarifying how breaches will be enforced.

Implementation by December 2017

The ABA developed the Code of Banking Practice. It began in 1993. The code was developed in response to consumer dissatisfaction with banking and was in part intended to forestall proposals that the Australian Government introduce statutory consumer protections for the banker consumer relationship. Originally it only applied to the supply of banking services to individuals (with the addition of taking guarantees from individuals).

The 2003 revision of the code extended most of its provisions to small business. Protections for guarantors did not extend to small businesses that give guarantees.

The ABA successfully lobbied to have the National Consumer Credit Protection Act 2009 (Cwth), restricted to consumer credit for personal and domestic purposes and hence that Act, including its responsible lending obligations do not apply to small business lending.

The ABA Code has recently been subject to an independent review by Phil Khoury “(the Khoury Report)”. The findings of that report will be discussed in a later section of the paper.

Recommendation 3

For all loans below $5 million where a small business has complied with the loan payments requirements and has acted lawfully the bank must not default a loan for any reason. Any conditions must be removed where banks can unilaterally.

- **Value existing security assets during the life of a loan;**

- **Invoke financial covenants or catch all "material adverse change' clauses;**

The report suggests that asset valuation is appropriate at loan inception and the roll over date.

The justification for the recommendation is that 98% of lending to small business customers is under $5 million and it would have the effect of redistributing risk between borrowers and banks.

The recommendation does seem to have been made in a vacuum with limited consideration of the prudential requirements banks are subject to by APRA.

Recommendation 4

A minimum 30 business days' notice period to all changes to general restriction clauses and covenants (except for fraud and criminal actions) be added to give borrowers more time to respond and react to a potential breach of conditions.

This would extend to general clauses like not changing a company's ownership structure.

The theory behind this proposal is to enable a small business the opportunity to respond to a breach of conditions, reducing the chance of a business in good financial standing being subject to a loan default.

There is a reason why loan documents provide flexibility to bankers - circumstances may be such that a security could be in jeopardy and providing a blanket 30 day moratorium could have the effect of damaging the value of a security significantly.

Recommendation 5

For loans below $5 million, banks must provide borrowers with decisions on roll over at least 90 business days before loans mature, so borrowers can organise alternative financing. A longer period of time should be given for rural properties and complex businesses that would take longer to sell or refinance.

The rationale for this recommendation is to provide greater visibility of loan roll over decisions, allowing borrowers to organise alternative financing should roll over be refused.

Recommendation 6

For loans below $5 million, banks must provide a one page summary of the clauses and covenants that may trigger default or other detrimental outcomes for borrowers.

This recommendation is part of the drive for simplifying terms for borrowers.

It is recommended that:

- Banks develop a short summary of the clauses and covenants that may trigger a default; and

- Included in that summary are what action the bank may take and what action the borrower may take if default is triggered.

Recommendation 7

For loans below $5 million, banks must put in place a new small business standard form contract that is short and in plain English.

The rationale is to better manage the small business lending relationship and that many of the clauses in existing loan contracts are not relied upon by lenders.

Recommendation 8

All banks must provide borrowers with a choice of valuer, a full copy of the instructions given to the valuer and a full copy of the valuation report.

The current practice is there is no mandatory disclosure of valuation instructions, valuation results or valuation methodology with borrowers despite borrowers paying for valuations - some banks already do this and some do not.

The rationale for the recommendation is to provide borrowers with greater visibility of the valuation process and outcome which they are paying for and is intended to provide the borrower more assurance the process is fair and reasonable.

Recommendation 9

Every borrower must receive an identical copy of the instructions given to the investigating accountant by the bank and the final report by the investigating accountant to the bank.

Standard loan documentation often includes the mechanism for a secured creditor to appoint an investigating accountant to review a customer's business.

This is a mechanism that can be utilised when the customer is non-conforming, a loan is due for roll over or the customers industry sector may be undergoing structural or regulatory change.

Whilst it may be a precursor to formal receivership, it can also lead to recommended improvements and/or a revision of the terms upon which the financier would be prepared to continue the finance relationship.

The nature of the role of the investigating accountant is largely governed by the scope of the assignment and can be utilised as a mechanism to assist a customer's business through a period of intensive care thus avoiding the need for a formal appointment.

Recommendation 10

Banks must implement procedures to reduce the perceived conflict of interest of investigating accountants subsequently appointed as receivers. This can be achieved through a competitive process to source potential receivers and by instigating a policy of not appointing a receiver who has been the investigating accountant to the business.

At present there is no legislative or industry barrier preventing an investigating accountant from being appointed as Receiver.

Indeed the industry guidelines formulated by ARITA, to manage conflicts of interest do not extend to receivership appointments. The rationale is that receiverships are essentially private, contractual relationships between the secured creditor appointor and the appointee, the terms of which are governed by the relevant deed of appointment.

Whilst the recommendation has some initial attraction the countervailing argument would be:

- It would be an imprudent professional who would jeopardise his/her objectivity not to mention his professional indemnity insurance premiums for the sake of a potential subsequent receivership appointment;

- The intellectual capital developed in the course of the investigating accountants assignment would be lost leading to increased costs for the borrower resulting from any subsequent receivership.

Whilst not directly on point there have recently been a number of high profile voluntary administrations wherein the formal VA appointment has been preceded by an extensive investigating accountant / informal workout style assignment.

The same such considerations have been used to justify what would otherwise appear to be a breach of the existing industry guidelines and there has been some legal gymnastics to justify the retention of the appointments in question.

One suspects these tensions will only become reconciled if the ‘turnaround culture' anticipated by the so called safe harbour provisions becomes more prevalent.

<u>Recommendation 11</u>

The banking industry must fund an external dispute resolution one stop shop with a dedicated small business unit that has appropriate expertise to resolve disputes relating to a credit facility limit of up to $5 million.

<u>Recommendation 12</u>

Banks must establish a customer advocate to consider small business complaints and disputes that may or may not have been subject to internal dispute resolution.

If a small business customer is not satisfied at the end of an internal review process they can take their dispute to the Financial Ombudsman Service “(FOS)”, through farm debt mediation “(FDM)” (if applicable) or to court.

<u>Recommendation 13</u>

External dispute resolution schemes must be extended to include disputes with third parties that have been appointed by the bank, such as valuers, investigative accountants and receivers and to borrowers who have previously undertaken farm debt mediation.

The jurisdiction of the financial ombudsman service does not allow consideration of disputes.

- Between a small business and third parties such as valuers, investigative accountants and receivers appointed by the banks;

- That have been subject to farm debt mediation, regardless of whether an outcome was achieved.

The only recourse for small business in such circumstances is the court system, yet small business often does not have the expertise / resources to challenge banks through the court system.

<u>Recommendation 14</u>

A national consistent approach to farm debt mediation must be introduced.

Nationally, the average broad acre debt more than doubled from 2000/01 to 2015/16 mainly due to an increase in the average size of Australian farms. Total rural debt increased to $69.5 billion as at September 2016 and bank funding accounted for approximately 95% of total institutional lending.

Under FDM schemes, a farmer cannot force a mortgagee to mediate a dispute, although refusal by the mortgagee to attend mediation can lead to a mortgagee being prevented from enforcing its rights under the mortgage for up to six months.

The intention behind farm debt mediation was to provide farmers with a chance for mediation before lenders enforce rights under a mortgage. Currently only NSW, QLD and VIC have legislative schemes in place.

The Farm Debt Mediation Act 1994 (NSW) states that a secured creditor cannot seize property of the farmer without first giving 21 days written notice of the intentions including the option of mediation.

If the farmer requests mediation and the creditor does not comply then an exemption certificate from enforcement may be issued.

From 27 April 2017, a regime of compulsory farm debt mediation was introduced in Queensland.

Under this regime, when a farmer is in default of a farm mortgage, the credit provider must initially serve the farmer an enforcement notice and a mediation information package.

The farmer may ask for mediation of the debt within 15 days of receipt of the notice. If the credit provider fails to mediate, the farmer may apply for an enforcement suspension notice.

If a farmer applies for this certificate the Queensland Rural and Industry Development Authority must provide the financier a show cause notice for the failure to mediate.

The ASBFEO has recommended a nationally consistent approach to Farm Debt Mediation.

Recommendation 15

ASIC must establish a Small Business Commissioner.

This recommendation acknowledges the importance of the small business sector to the Australian economy.

Regardless the specific needs of small business are often overlooked in the regulatory process and the introduction of a Small Business Commissioner in ASIC is intended to address this oversight.

Conclusion

One of the ABA's submissions to the inquiry noted the following:

- *'For the year ending March 2015, less than 1% of business and agribusiness customers had impaired loans and a tenth of 1% were in recovery action. In only a handful of cases were substantial changes to LVRs (loan to valuation ratios) the major factor that created the impairment of the loan the overwhelming majority of defaults were a result of monetary breaches of the loan covenant or a combination of both monetary and non-monetary breaches'.*

Simply focusing on these raw statistics would indicate that in the vast majority of cases, loan finance operates as intended and leads to beneficial outcomes for both financiers and their customers.

That would tend to suggest that some of these recommendations represent a wish list and potentially amount to using a sledge hammer to crack a walnut.

However, the review received submissions from extreme examples of poor outcomes and as is often the case in industries which find themselves subject to regulatory oversight it is the minority which influences the ultimate outcome for the majority and it is emblematic of an environment when the banking community may have little option but to adopt a number of these recommendations or a variant thereof.

One suspects the findings of the Carnell inquiry will at least partially inform the findings of the Financial Services Royal Commission

On this basis, it would be an optimistic assessment that all of the recommendations or some variant thereof of the ASBFEO could be shelved indefinitely.

The Khoury Report

On 20 February 2017 Phil Khoury an independent governance expert released his report on the 'Independent Review of the Code of Banking Practice'.

The report acknowledges a primary driver of reviews of the code is the level of dissatisfaction with the banking sector in the community and the need to restore trust in the community.

That said it is important not to overstate the overall significance of the Code given that banks regulatory obligations include in addition to the code, three major acts of parliament, case law and two other legally binding codes i.e.

- National Consumer Credit Protection Act and National Credit Codes;
- ASIC Act – unfair contract forms provisions;
- Corporations Act;
- Privacy Act & Credit Reports Code;
- Anti-Money laundering legislation; and
- E Payments Code.

The review made 99 recommendations across a range of areas including:

- Small business
- Responsible lending
- Credit card lending
- Credit cards and borrower default
- Joint account holders
- Guarantors
- Dealing with customers with financial difficulty
- Terms and conditions and charge backs
- Fees
- Sales practices including insurance cross selling
- Customers with special needs
- Complaints policy
- Code monitoring and compliance

Some of the more significant recommendations include the following:

- **Recommendation 5** – broadens the definition of small business to include any business with fewer than 100 employees and where the business has a credit limit of less than $5 million per credit facility.

  Currently the Code defines a 'small business' as a business having less than 20 full time equivalent employees or 100 employees in the case of a manufacturer.

- **Recommendation 11** – provides that the Code should be amended to require a signatory bank to provide a customer in default under a small business facility below $5 million with 30 days' notice before beginning enforcement proceedings. An exception would apply where the bank reasonably believes more urgent action is necessary to recover the debt or avoid loss in value of the security for the credit.

  Indicative data provided by 8 signatory banks as at the end of March 2015 provides comfort that the vast majority of small businesses are successfully servicing the credit provided by their signatory bank.

  - Less than 1.5% of loans to small business (farming enterprises and other enterprises) were in work out;

  - Less than 0.5% of loans to small business were subject to loss provision as impaired loans (a loan is typically classified as impaired where the loan is 90 days overdue;

  - Less than 0.02% of loans to small business in recovery action (where loan foreclosure has occurred); and

  - Farming enterprises were to twice as likely to be in work out, impaired or recovery as compared with non-farming small business loans.

- **Recommendation 12** – provides that the Code should be amended to require a signatory bank to have in place adequate arrangements to address conflicts of interest issues pertaining to proposed appointments of investigating accountants and receivers.

  The Khoury recommendations do not appear quite as prescriptive with respect to this issue as the Carnell Report which would prescribe the practice of appointing investigating accountants as subsequent receivers.

- **Recommendation 99** – recommends that the revised code be submitted to ASIC for approval under Corporations Act Section 1101A and Regulatory Guide 183.

  The rationale for this recommendation is to enhance community acceptance of the revised code.

The report itself acknowledges that an inadequate response to its recommendations would simply engender further cynicism in the general community with respect to the banking industry's commitment to genuine reform.

This would also be the case if there was inertia or attempts to water down the recommendations or create extensive carve out from the spirit of the recommendations.

It was announced on 31 July 2018 that ASIC has approved the ABA's new code of Banking Practice and it will commence operation from 1 July 2019.

It would appear that ABA has been successful, at least for the time being of limiting the concept of small business borrowers to loans of up to $3 million. The code provides that such loans should not contain a range of potentially unfair and one sided terms.

At the current setting of loans up to $3 million the code will cover 92-97% of business in Australia.

ASIC's approval is conditional on an independent review of the definition of small business within 18 months of the codes commencement in July 2019 to ensure a high level of coverage of the small business sector.

ASIC has acknowledged it may review its approval of the code, following the findings of the Financial Services Royal Commission.

Implications of Royal Commission

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry commenced public hearings at the beginning of the year and is due to submit an interim report no later than 30 September 2018 and is due to provide a final report by 1 February 2019.

The Royal Commission hearings have captured a significant degree of public attention with evidence of potential wrong doing and less than optimal consumer outcomes arising from the business activities of some of the country's largest financial institutions.

Obviously we cannot identify precisely what the recommendations of the Royal Commission will be, although it is possible to identify some general themes arising from the evidence to date and perhaps identify some implications for the non-bank finance sector.

Practical Effects

Anecdotally the Royal Commission already seems to have some practical effects on the finance community, notwithstanding it has yet to report its findings:

- Access to credit:

  Anecdotally it has been more difficult to source bank credit since the commencement of the Royal Commission. This has had the effect that some non-bank lenders have actually been able to improve the quality of the customers they have been able to source.

  Credit criteria have also been tightened which has been an ongoing process through the successive inquiries the banking sector has been subject to.

- A number of major banks have announced either demergers or reductions of their shareholdings in major housing loan aggregators.

- A number of major banks have announced their intention to uncouple their vertical integration models in the financial advice space.

Themes

Some recurrent themes can be identified:

- The regulators in the sector, in particular ASIC have come in for criticism for permitting the climate in which some of the behaviour identified in the Royal Commission has occurred.

  ASIC has also been criticised for over reliance on enforceable undertakings rather than seeking curial sanction of breaches of the law through the courts.

  Accordingly it is likely that in the short term to medium term ASIC will be compelled to enforce financial services law through the courts.

- Given the evidence heard before the Royal Commission it is unlikely that banks and financial services firms will be able to call upon self-regulation and competition as adequate safeguards against poor outcomes for customers.

  Accordingly it is likely further prescriptive regulation will be introduced which will add to the cost of credit and financial services for consumers.

  There is a possibility that such regulation could include individual accountability at the director / executive level for the behaviour of staff subject to their oversight.

- An ongoing theme of the Royal Commission has been the concept of community expectation and the concept of social licence in the banking and financial services space.

- In the residential mortgage space, the Royal Commission seemed to have some difficulty with broker remuneration, in particular trail commission i.e. trail commissions may result in a conflict of interest with the consumers interests.

  The concept of an upfront flat fee payment or fee for service model has been floated by counsel assisting the commission as a possible alternative to the current structure.

Non-Bank Financiers would be sitting in an echo chamber If they did not at least consider possible implications of the Royal Commission, to their sector.

Whilst it is acknowledged that non-bank lenders often have higher rates of interest reflective of their risk profile and that they are usually outside the consumer space there is every possibility that increased scrutiny will be placed on the sector, particularly if more and more traditional bank customers are compelled to use their services.

Further there has been increased regulatory focus on small business lending which is the natural focus of a large component of the non-bank sector.

In particular non-bank financiers should be aware of the following:

- Possibility of increased regulatory and potentially prudential oversight

- The influence of the concept of 'community expectations' on the regulatory climate.

- Focus of regulators on 'unfair' contractual terms in the small business space.

- The commission structures payable to their broker distribution channels.

In conclusion it appears we are entering an era of prescriptive regulation, particularly arising out of the findings of the Royal Commission and the government's attempts to restrict phoenix behaviour.

This does sit somewhat uncomfortably with the more laissez faire style of regulation underlying the safe harbour, Ipso Facto and bankruptcy reforms of the last 18 months.