Law Council
OF AUSTRALIA

Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

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About the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Law Firms Australia, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 60,000 lawyers across Australia.

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

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- Mr Tass Liveris, Executive Member
- Ms Pauline Wright, Executive Member
- Mr Geoff Bowyer, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.

Acknowledgement

The Law Council acknowledges the assistance of the Law Council's Business Law Section, in particular, the Financial Services Committee, the Corporations Committee and the Small and Medium Enterprise Committee, in the preparation of this submission.

The Law Council is also grateful for the input of the Law Institute of Victoria, the Law Society of New South Wales, Law Society Northern Territory and the Law Society of South Australia

Executive Summary

1. The Law Council of Australia is pleased to make this submission in relation to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**the Commission**).

2. This submission was prepared by the Business Law Section (**BLS**) of the Law Council of Australia (the Financial Services Committee, the Corporations Committee and the Small and Medium Enterprise Committee) and also reflects input the Law Council has received from its following Constituent Bodies: the Law Institute of Victoria, the Law Society of New South Wales, Law Society Northern Territory and Law Society of South Australia.

3. In summary, the Law Council:

- submits that the law should be simplified, with a key focus on the principles already embodied in the law, such as acting honestly, efficiently and fairly, not misleading, and acting in the best interests of the customer;
- suggests that radical simplification which changes core compliance obligations should be avoided due to the substantial cost which would be borne by business and ultimately by consumers;
- cautions against extending a ‘best interests’ duty beyond the circumstances where the relationship with an intermediary is of a fiduciary character – rather it should be made clear to consumers that they are not in an advisory relationship, rather the opposite, they are being sold to by the intermediary;
- recommends that this include simplifying the information consumers receive from their financial advisers;
- notes that many of the issues raised in the Interim Report demand a careful and considered response to law reform at a fundamental policy level that capitalises on the experience since the introduction of the financial services and consumer credit regimes to build on the successes and target the failures of the existing frameworks, and leverage the results of advances in behavioural economics and psychology (for example to reduce the reliance on disclosure as the foundation of consumer protection and to recognise the behavioural biases of consumers’ decision-making); and
- accordingly, recommends a referral to the Australian Law Reform Commission (**ALRC**) to develop propositions for simplification and related matters identified in this submission.

Part 1 – Introduction and overview

4. As the Executive Summary to the Interim Report notes:

   - the law already imposes relevant obligations to act honestly, efficiently and fairly, not to mislead, and to act in the best interests of the customer;
   - the law and regulation in this area is particularly complex; and
   - much of the conduct examined in the case studies before the Royal Commission was contrary to law. There are already actions which could be – and in some cases, have been – pursued by regulators with respect to much of that conduct.

5. Financial institutions have, at great expense, put in place procedures and training to comply with the complex array of law and regulation. However:

   - the case studies the subject of the Royal Commission demonstrate that the regulated entities have at times focused more on the detailed rules than on taking a step back and asking whether the conduct was honest, fair and in the best interests of the customer; and
   - well-motivated regulation has (somewhat ironically) led to confusion and lack of transparency between the roles of selling to, and advising, customers. It would be undesirable to add to this confusion by, for example, extending obligations to intermediaries who are not fiduciaries. It would be preferable to be clearer and more transparent about the intermediary's role and in whose interests they are acting.

6. In that context, the Law Council submits that the Commissioner is correct to query what it would gain by adding some new law, which would add complexity to an already complex regulatory regime.

7. The Law Council supports the idea of simplifying the law based on the key principles. Radical simplification that changes core compliance obligations would be problematic, as the cost to business involved in adapting to significantly revised obligations would be substantial.

8. Importantly, it is key that the simplification of the law results in clearer information for consumers. Competition is best served when the differences between vendors are clearly visible and there is reduced information asymmetry.

9. The *Corporations Act 2001* (Cth) (**Corporations Act**), in particular Chapter 7, and the *National Consumer Credit Protection Act 2009* (Cth) (**NCCPA)** would benefit from simplification to improve regulatory coherence, and a clearer focus on overarching core principles. The Law Council recommends a referral to the ALRC to develop propositions for simplification.

10. Parts 2 to 7 below address several of the issues identified in the report which go to the appropriate law reform in relation to financial services generally. Rather than answering each of the questions posed by the Commission, this submission largely discusses law reform issues at a policy level. Once the policy is settled the detail of the legislation to implement it can be debated.

11. Part 8 below addressed the Commission's questions regarding Small and Medium Enterprises (**SME**). The Law Council's BLS has a designated SME Committee, and this section has been prepared by the SME Committee which is well placed to

address those matters which raise distinct considerations from the balance of this submission.

Part 2 – Context

12. Treating consumers fairly and honestly has important economic consequences, as the by the Commission at page 21 of the Interim Report. The case studies illustrate that the high standards the community rightly expects of banks and insurers have in many cases not been met. Significant issues which have arisen in relation to consumer lending and financial advice.[1]

13. Yet, the very clear message at the heart of the vast range of questions posed (and issues raised by the Commission) is that the labyrinth of legislation, regulation, regulatory administrative exemptions and regulatory policy guidance governing the sector has failed in many respects, often fundamentally so.

14. The conclusions drawn by the Commission regarding consumer lending and financial advice, and the associated issues raised for consultation, reflect a range of inter-related root causes which need to be addressed at their source. The current credit and financial services regimes arose from a process of inquiry, review and consultation with industry over many years, beginning in the 1970s and culminating in the 1997 Financial System Inquiry (**the Wallis Inquiry**) and Corporate Law Economic Reform Program 6 (**CLERP6**) in the late 1990s (surveyed by the Commission at pages 75-77 of the Interim Report). The Law Council finds this history to be very important in understanding the current issues of concern to the Commission and notes the following observations of the Commission in particular:

    - the banking system was a regulated, local, low risk business until the 1970's;
    - before the 1980's those who required financial advice may have gone to their accountant or insurance adviser;
    - as the retail financial markets grew, product manufacturers looked to financial advisers to sell those products, who at the time came predominantly from a background in life insurance which was a sales-driven commission-based culture in which comprehensive advice was uncommon. From these roots, that culture has survived in today's financial planning industry;
    - in 1997 the Wallis Inquiry recommended that the current fragmented regulation of the financial system be unified under 'a consistent and comprehensive disclosure regime'; and
    - in 1999, CLERP6 was released. Notwithstanding amendments in the period since enactment of the reforms it recommended, a number of its underlying principles endure, including to fold sales and advice relating to superannuation and insurance into the regulation of financial products. CLERP6 did not provide that financial advisers were to be independent from product issuers and it is not clear whether the now widespread practice of financial advisers being employed or authorised by the issuers of the products about which they advise was considered by the CLERP6 writers (page 78 of the Interim Report).

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[1] The Law Council also notes with concern the issues raised relating to the treatment of Aboriginal and Torres Strait Islander people and people with disabilities, albeit this submission focuses predominantly on the issues which have arisen in financial advice and consumer lending generally.

15. Yet, these refinements and amendments since the introduction of the credit and financial services regimes have not uniformly been successful. The Commission notes for example the Reserve Bank submission to the effect that Wallis underestimated banks' capacity to expand and acquire businesses along their supply chain (page 79 of the Interim Report).

16. Perhaps in response to this lack of success, banking financial institutions have taken action in relation to industry self-regulation by amending the Australian Banking Association's Banking Code of Practice which has been approved by the Australian Securities and Investment Commission (**ASIC**) and will commence on 1 July 2019. It is understood that the new Banking Code of Practice will require signatories to engage in responsible lending, provide increased transparency of financial services and provide for significant new legal protections for small business borrowers.

17. Many of the issues identified by the Commission have been previously raised. ASIC's conclusions in regulatory reports investigating and comparing the quality of advice in different industries under different remuneration models (e.g. assessing advice given under commission vs fee for service customer relationships) produced some startling conclusions, noted by the Commission, but little action. The comments of the Commission in relation to 'doing the right thing' reflect recent similar comments in the report flowing from the Australian Prudential Regulation Authority's (**APRA**) review of the Anti-money Laundering/Counter Terrorism Financial (**AML/CTF**) compliance issues at the Commonwealth Bank of Australia. Industry is on record as recognising these issues among others but, as the Commission itself notes, has proven itself unable to address them, as have the regulators.

18. The nature of these problems is such that they will not be addressed by further additional layers of regulation tacked onto the existing regime. Rather the issues demand a careful and considered response to law reform at a fundamental policy level that capitalises on the experience since the introduction of the financial services and consumer credit (NCCPA) regimes to build on the successes and target the failures of the existing frameworks, and leverage the results of advances in behavioural economics and psychology (for example to reduce the reliance on disclosure as the foundation of consumer protection and to recognise the behavioural biases of consumers' decision-making).

19. In Chapter 8 of its Interim Report, the Commission restates the issues under a number of general categories. The following submissions reflect a number of those categories.

Part 3 – Access

20. It is self-evident that the cost of compliance is passed on to the consumers of banking services and therefore affect access. Efficient and effective regulatory regimes that foster good compliance outcomes will facilitate access to credit and financial services by allowing these services to be provided at least cost, without causing harm to those customers.

21. The current approach of regulators and gatekeepers to responsible lending obligations in the consumer credit industry does have the potential to threaten adequate and appropriate access to credit. Anecdotally, members of the BLS have observed that ASIC, and some advisers closely connected with it, appear to impose ever-widening requirements on lenders to investigate and verify the expenditure of loan applicants in ways that stretch the link to responsible lending requirements to

make reasonable inquiry of the borrower's financial situation. The obligation to verify the consumer's expenses asserted by ASIC and accepted as self-evident by the Commission (discussed further below) is one example of this which is currently the subject of judicial consideration in the Westpac case.

22. Other anecdotal examples of such requirements include an insistence by a 'Big 4' audit firm that scheduled but voluntary payments (such as a voluntary superannuation contribution made in the previous year) are liabilities that must be included in a responsible lending assessment. There is a risk that the pursuit of the objective to protect customers from themselves could lead lenders to tighten credit standards and ration credit to mitigate compliance risk associated with the apparently arbitrary interpretation and enforcement of a poorly defined statutory obligation.

23. The prevalence of Household Expenditure Measures (**HEM**) as a benchmark readily transmutes into use as a target to indicate an appropriate level of expenditure at which 'reasonable inquiry' can cease. ASIC is understood to require of some lenders with which it engages to set targets for the number of loan applications that 'meet' HEM. If HEM is not met, the prudent lender in these circumstances would decline the loan, effectively because the borrowers' circumstances are a statistical outlier, not because of any inability to understand the relevant person's financial situation.[2]

24. In financial services, customers with a simple need for certain products such as life insurance and who engage a financial adviser to assist them in assessing a suitable product for them, find themselves obliged to obtain personal advice that must consider their broader financial circumstances and be documented in a voluminous Statement of Advice much of which is intended to protect the adviser rather than assist the client, locks the client into a nominally ongoing relationship with that adviser that the client does not necessarily want or need. While the costs of these requirements may not be borne by the client directly if the adviser (historically before changes prevented this) received commission from the product issuer and is not in a fee for service arrangement with them, ultimately the consumer pays indirectly for these overheads.

25. Another key concern is that information asymmetry acts as an inhibitor to the consumer's access to banking services. The complexity of banking services and products has had unintended anti-competitive effects and resulted in consumers being highly dependent on the interpretative abilities of costly banking services advisors and intermediaries. For example, financial product disclosure statements and mandatory contractual loan documents are significantly complex and challenging for consumers to understand. Market forces have not, and are unlikely to, facilitate a situation where consumers are positioned to easily compare banking services and products without assistance from intermediaries and financial services advisors.

26. The Law Council proposes that the Commission recommend that a referral be made to the ALRC to review and develop proposals for simplification including consideration of how the information presented to consumers can be simplified so that it is more relevant and concise.

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[2] The Law Institute of Victoria use of the higher of 'actual verified household expenditure' or 'the HEM'.

Part 4 – Intermediaries

27. The financial services distribution network is premised on the assumption that financial products are complicated, and that advice is required to navigate them. In fact, however, the advice provided is often not regulated (i.e. if an exemption applies) and is conflicted.

28. In the case of many credit and financial products, the customer's 'needs' may be simple, and advice may not be required, but the regulatory regime characterises the customer relationship as one of adviser/client when the remuneration arrangements establish incentives that are sales based but disguised from the consumer. In the example of an individual seeking life insurance raised in section 3 above, for example, the customer may be seeking a one-off transaction to meet a need for basic cover and the meeting with the financial adviser may be essentially be a sales conversation (and the commission-based adviser is remunerated consistently with this analysis) but the regulatory regime requires the adviser to 'dress up' the relationship as an ongoing advisory relationship and therefore create confusion about the interests he or she is representing. It is to be noted that there was a law reform proposal some years ago to create a third 'kind' of (sales-based) financial advice to acknowledge this reality, which did not proceed for reasons which the Law Council understands included a concern about the additional complexity this would create (with which the Law Council agrees).

29. There are counterviews to this position. For example, the Law Institute of Victoria proposes that:

    - the existing duties owed by an intermediary to a borrower should be expanded to require intermediaries 'to act in the best interests of a borrower, and in good faith'; and
    - in the case of fraud or other misconduct by an employee or intermediary a licensee should inform its clients of the reason for the termination of the licensee's employee or intermediary for fraud or other misconduct if the licensee or employee was directly involved with the client's loan, in order to ensure that the client is in a position to respond to the licensee in respect of the fraud or other misconduct.

Part 5 – Responsible lending

30. The principles of the responsible lending regime are simply stated but in practice have clearly proven difficult to interpret and apply. The difficulties of assessing the degree of inquiry that is reasonable invites short cuts by lenders (such as the use of benchmarks) and strategic behaviour by borrowers.

31. The issues the Commission raises for consultation are based on the premise that the underlying responsible lending regime is sound. However, the premise that lenders are a better judge of otherwise competent individuals' best interests than the individuals themselves deserves re-examination. Forgoing one's discretionary spending (say on private school fees) may be considered great hardship by one person but recognised as dispensable luxury by another. The picture is further clouded by the obvious incentive of both lender and applicant to find the loan not unsuitable. The growing understanding of behavioural psychology could be instructive in reconsidering the current approach.

32. The concept of reasonableness requires the impact of the loan on the consumer's discretionary income to be considered and when this is large, in the context of a small loan, the cost of making that loan becomes sufficiently large that issues of access to credit arise. Both the cross-subsidisation of these applications requiring more investigation by those that require less and a user-pays approach have undesirable effects. In these circumstances, again, it seems appropriate to reconsider the underlying obligation.

33. The current responsible lending obligation requires the consideration of the consumers' financial situation. Yet this financial situation is impossible to disentangle from that of the consumers' household. ASIC's approach (accepted by the Commission) that a consumer's financial situation consists of an assessment of their income and liabilities does not reflect the infinite variety of household circumstances (such as the practice of income sharing by spouses) or the difficulty consumers face in supplying reliable comprehensive information about their expenditure in particular.

34. Again, a counterview is expressed by the Law Institute of Victoria, which suggests an approach which would add further regulation, including that:

- adding a requirement that a lender has to act in the best interests of the consumer would further promote responsible lending;
- lenders should be required to review, and independently verify, disclosed expenses and the financial circumstances of borrowers using secondary data point examination such as Bank Statement Analysis by automated systems or manual verification;
- mandating the submission of a quarterly compliance report by lenders to the relevant regulator may improve reporting of systemic failure of lenders to detect and prevent breaches of responsible lending obligations by intermediaries;
- with respect to financial services that fall outside the NCCPA such as newly introduced financial loan schemes including 'rent to buy' and 'buy now pay later', there is the need for additional regulation and further consumer protections; and
- ASIC should be provided with 'product intervention powers' to require changes or even discontinuation of products.

Part 6 – Regulation and the regulators

35. Whilst the existing laws and policies in relation to the provision of banking and related financial services are generally adequate, as identified by the Commission, it is suggested that the degree of consistent enforcement of the laws and policies is currently inadequate and strengthening of enforcement of existing laws should be prioritised.

36. The Law Council supports **simplification**, and notes:

- in light of proposed reforms, ASIC has sufficient regulatory tools;
- traditional litigation by itself is not a sufficient or effective enforcement tool, in light of the costs and time involved, and the procedural emphasis;
- a referral to the ALRC, as recommended by the Law Council, include assessment of a proposal to consider court supervised negotiated penalties, compensation and undertakings; and

- APRA's prudential focus, regulatory and enforcement practices are sufficient.

Is the law too complicated?

37. The nature of the problems discussed above is such that they will not be addressed by further additional layers of regulation tacked onto the existing regimes. The Commission indeed observed that the existing regulatory regimes are complex and that most of the condemned conduct was contrary to the existing law. The Commission asks whether adding an extra layer of complexity would improve outcomes.

38. For many years since the inception of the Australian Financial Services Licence (**AFSL**) regime the outcomes of many enquiries and reports have been predictable. All or most recommendations have been accepted by the Government of the day and new regulatory layers have been added to address the perceived issues in isolation. The Commission's Interim Report documents this history and its findings to date make it clear that this approach has not been effective.

39. The issues raised by the Commission beg the question: has the increasing complexity of the financial services and credit regimes added to the problem? As complexity increases, more and more attention must be given to technical issues associated with understanding and implementing the requirements of the law. Perhaps this preoccupation with the prescriptive legal requirements has directed attention away from the more fundamental policy issues such as:

    - Are consumers always the best judge of their own interests? To the extent they are not, is disclosure the best or only approach? Different aspects of the current regime have different answers to this question not necessarily founded in principle.
    - What do consumers really need to know about financial products and services they are considering – is the large amount of detailed information disclosed actually obscuring what is most important to their decision making?
    - Are consumers information-overloaded and therefore fatigued? How do they respond to information overload? Can the cognitive shortcuts identified by behavioural psychologists be addressed by regulatory measures?
    - How can providers be incentivised to do what is right and what is fair?

40. The Law Council supports the conclusion by the Commission that weak competition is one of the reasons deterrents to misconduct have not been greater. Perversely, increasing complexity to address compliance issues can act as a barrier to entry with an anti-competitive and anti-consumer effect because the threshold investment in compliance measures required makes it harder for smaller players in the market to gain a foothold and keep the larger players 'honest'.

Recommendations

41. The Corporations Act, in particular Chapter 7, and the NCCPA would benefit from simplification to improve regulatory coherence, and a clearer focus on overarching core principles.

42. The Law Council recommends a referral to the ALRC to develop propositions for simplification.

Further observations

Core principles

43. The Law Council endorses the Commission's statement of core principles, namely:

- obey the law;
- do not mislead or deceive;
- be fair;
- provide services that are fit for purpose;
- deliver services with reasonable care and skill; and
- when acting for others, act in the best interests of that person.

44. However, the Law Council cautions against extending a 'best interests' duty beyond the circumstances where the relationship with an intermediary is of a fiduciary character (see further discussion under heading 'Roles of Intermediaries and Business Structures' below).

Simplification

45. The Law Council endorses the Commission's observation that additional layers of regulation will only further distract attention from the core principles underpinning the laws regulating the financial sector.

46. Radical simplification that changes core compliance obligations is problematic, given the cost to business involved in adapting to significantly revised obligations would be substantial.

47. However, simplification is necessary to ensure regulatory coherence and the clearer articulation of core principles in the web of legislation that governs the financial sector – including the Corporations Act, the NCCPA, the Competition and Consumer Act (**CC Act**), and the Australian Securities and Investments Commission Act (**ASIC Act**), and the codes, regulations and legislative instruments made under them.

Examples of complexity that cause concern

48. For instance, the effectiveness of regulatory systems and obligations in the Corporations Act has been adversely affected by (amongst other things):

- an inappropriate application of the concept of 'financial advice', to include communications that are not advisory in character – which has misled investors and consumers as to the true character of interactions with some intermediaries;
- the application of Chapter 7 to a combination of investment products and consumer products, producing a regime that is not well suited to either;
- an inexplicable differentiation between regulation of listed securities under Chapter 6D and other listed financial products under Chapter 7;
- the insistence in Chapter 7 on formulaic communications to investors and consumers that obscure clear communication; and
- while class orders are important to address errors and anomalies in legislation and to adapt swiftly to evolving market circumstances, there have been many examples of unreasonable delays in incorporating well-tested amendments made by class orders into principal legislation.

49. Similarly, the (at times) overlapping regimes created by the Corporations Act, the NCCPA, the CC Act and the ASIC Act to regulate consumer financial products and associated conduct in relation to those products is unduly complex and risks blurring the coherence of the underlying policy.

50. In each case, tangled interaction between principal legislation, codes, regulations and legislative instruments creates uncertainty and unduly technical analysis as to which rules apply.

Should there be annual reviews of regulators' performance?

Recommendations

51. The Law Council continues to support the recommendation of the 2014 Financial System Inquiry for the establishment of a Financial Regulator Assessment Board, for balanced annual reviews and to provide an effective forum for consideration of reforms that support effective and efficient regulation.

Further observations

52. The Law Council is, however, concerned that any forum for review of regulators' performance should demonstrate a balanced approach. An approach that focusses only on failings can lead to undue conservatism and inflexibility on the part of regulators that is not conducive to efficient and effective regulation.

53. Strengths and achievements should be recognised as well as areas for improvement, and regulatory innovation should be encouraged to support growth and reduction of red-tape.

54. Similarly, ambit claims between regulators for regulatory 'territory' should not be encouraged.

Is ASIC's remit too large?

Recommendations

55. ASIC has a wide range of responsibilities. In this area of markets and securities laws, it is widely seen as having done a good job. The consumer products area which has been subject to the scrutiny of the Commission is only one aspect of ASIC's role.

56. ASIC should be the regulator responsible for administration and enforcement of securities laws and conduct regulation in relation to investment products, financial markets and intermediaries. These are areas of strength for ASIC and its depth of understanding is beneficial in regulating, and mitigating the risks of, those markets.

57. If ASIC's remit is to be divided – regulation of financial products that are consumer products (as distinct from investment products) could be separated into a separate division of ASIC with separate Commissioners, as there is existing power to do under section 97 of the ASIC Act.[3]

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[3] The Law Institute of Victoria submits that to ensure consistent and robust enforcement of the legal framework and community standards in relation to financial services, an adjustment of the roles of the, Australian Competition and Consumer Commission (**ACCC**), APRA and ASIC to align their regulatory focus

Further observations

58. Effective regulation of financial products involves a sophisticated understanding of the financial sector, financial markets and financial products.

59. The Law Council cautions that simply moving regulatory responsibility from one regulator to another may create a similar problem in another location and create further blurring of underlying policy.

Does ASIC have enough regulatory tools?

Recommendations

60. The regulatory tools available to ASIC and APRA are broadly sufficient (noting proposed reforms to the law in relation to penalties).

61. ASIC has suggested that its ability to pursue compensation awards are limited, and the Law Council would endorse greater flexibility for ASIC, in appropriate cases, to establish compensation funds as a potential alternative to the complexity of class action proceedings, provided that it did not duplicate exposure to liability.

62. The Law Council endorses reforms to increase penalties applicable to established contraventions of the law, but does not support expansion of infringement notice regimes.

63. There is substantial academic economic research literature discussing the incentives created by enforcement regimes both on the regulated population and the regulators. Economists tell us, for example, that increasing penalties can have the perverse effect of decreasing enforcement activity as 'raising the stakes' in this way can lead regulators to be more cautious about seeking to exercise their increased powers. It is understood that the response to the introduction of draconian environmental clean-up laws is an example. It is intuitively correct to say that where the 'standard' penalties are overly strong, there is an inbuilt incentive for regulators to not seek them.

64. Any reconsideration of the enforcement regime should be informed by, among other things, an investigation of the potential incentive effects using behavioural economics tools to consider the potential incentives on regulators and the regulated population.

65. Similarly, in relation to the assertion that 'penalties are far too low', the position is more nuanced than that statement may suggest. The Law Council considers that penalties for pervasive and systemic issues could well be said to be low relative to the potential benefit of the offence to the offender, and are to be contrasted, for example, with the penalties that apply to breaches of the competition laws (in Australia and in the European Union). However, it is also true that the penalties that apply to single events can in some circumstances be inappropriately high, such that when the single event is part of a systemic process and repeats (say 10,000 times), a court finds it difficult to charge the full maximum penalty for each offence.

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would be beneficial. The Law Institute of Victoria considers that the granting the ACCC additional powers to regulate the activities of financial services in relation to consumer protection, which would supplement the existing regulatory functions of ASIC, would be of further benefit. The Law Institute of Victoria also supports the Commission's provision of additional powers to regulators to monitor and regularly audit the internal systems of financial services entities to deliver financial services as expected by community standards.

66. An example of this may be seen in the consumer credit laws. The standard penalty for a single process failure on a $2,000 personal loan is $2.1 million and imprisonment for 2 years. It is probable that a single such issue may give rise to a number of separate offences under several different statutes, each with a penalty of $2.1 million. The issue is then compounded when that process failure relates to a high-volume systemic issue and is repeated perhaps thousands of times within a short space of time even if it is detected and corrected with diligence by the credit provider.

67. The result of this in practice may be seen in the outcomes of the recent actions by Australian Transaction Reports and Analysis Centre (**AUSTRAC**) against Tabcorp and the Commonwealth Bank of Australia (**CBA**), in which the cumulative penalty applicable to the offences to which the defendants in these cases admitted was so large that it essentially amounted to a bargaining chip that the regulator used as an opening gambit in a negotiated outcome. It is important that the penalty regime applicable to systemic breaches of this nature should be principled, public and proportionate to the conduct the subject of the penalty. The risks where that is not the case are apparent in the current litigation brought by ASIC against Westpac concerning responsible lending breaches, in which the court, having been asked to approve the agreed outcome by consent is seeking the assistance of *amicus curae* to discern what offence, if any, arises from the conduct which Westpac has conceded it engaged in.

68. As noted above, a considered return to fundamentals is required, informed by enforcement policy but also by an understanding of the circumstances in which the offences may occur (including, their systemic nature, the period over which they occurred, the extent of the benefit, and the relative economic power of the parties to the relevant transactions) and the principles of behavioural economics as to how regulators and regulated may respond to the proposed regime.

ASIC's enforcement strategies

Recommendations

69. Litigation is an important enforcement strategy, and the Law Council supports greater enforcement activity by ASIC – but cases should be chosen with care and should be prosecuted swiftly.

70. It is not an appropriate use of public funds (nor an appropriate impost on business) for a regulator to pursue doomed litigation as a means of lobbying for regulatory reform, and comments in the Interim Report that appear to endorse that approach are troubling. If there is a need to take such actions to secure reform, then the need might be addressed in other ways.

71. There is a pressing need to achieve meaningful enforcement outcomes in a reasonable timeframe, together with communication of key principles to the market.

72. Court-enforced undertakings are a useful enforcement strategy, notwithstanding the Commission's criticisms, given the time and costs involved in traditional litigation, and the congestion in the courts.

73. The Law Council considers that a court-supervised model, to ensure that penalties and compensation amounts are appropriate, would improve outcomes and effectiveness while still offering an opportunity for the court to signal key principles. This could be considered in a referral to the ALRC.

74. As noted above, the Law Council recommends against the use of infringement notices.

Further observations

75. The Law Council's concern with infringement notices is that penalties should not be applied where a contravention has not been established. Infringement notices can contribute to:

- On the part of regulators – use of notices in circumstances that:
  - do not warrant regulatory action; or
  - relate to deliberate breaches carrying far larger maximum penalties but that the regulator declines to more fully investigate as a substitute for full and appropriate enforcement action reflecting the severity and deliberate nature of the relevant contravening conduct;
- On the part of regulated entities – a perception that notices are issued in situations where there is not a genuine contravention, and an attitude towards potential contraventions of 'pay to make the regulator go away' rather than proper engagement on the substance of the regulatory concern.

76. While convenient for the regulator, these practices come at a reputational cost, creating scepticism amongst regulated entities and in the community as to the credibility of a regulator prepared to act in an arbitrary way to obtain a result that is driven by administrative process and convenience rather than the severity of the offence or other wrong potentially committed.

77. Similarly, while the Law Council generally supports substantially increased penalties for contraventions of legislation proposed by the Treasury's ASIC Enforcement Review (other than proposals in respect of infringement notices),[4] it remains concerned that there should be proportionality between penalties and culpability.

78. Noting the ALRC inquiry into class actions, there should be consideration of more efficient means of providing compensation for contraventions.

Further submissions made by the Law Society of New South Wales

ASIC's limited powers

79. The ASIC Enforcement Review Taskforce has recommended that ASIC's powers be expanded, and some penalties increased.[5] Final adoption of those recommendations may depend upon the recommendations made by the Royal Commission. The Law Society of New South Wales suggests that the effect of making those changes will depend on the way in which the provisions are implemented. In particular, it is suggested that increasing penalties for misconduct will only have a limited deterrent or punitive effect unless the regulator shows greater willingness to pursue increased penalties.

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[4] The Treasury, *ASIC Enforcement Review Taskforce Report* (December 2017).

[5] The Treasury, *Financial Services Royal Commission Background Paper No 24: Submission on Key Policy Issues* (July 2018) 25 [92].

Litigation and regulation

80. The ASIC Capability Review found that ASIC's litigation strategy is risk averse and that ASIC does not regularly pursue strategically important litigation.[6] Only 41 per cent of external stakeholders agreed that 'ASIC deters individuals or organisations from engaging in misconduct'. Only 23 per cent of external stakeholders, and 37 per cent of ASIC senior executive leaders and Commissioners, thought that 'ASIC acts quickly to investigate potential breaches of the law'.[7]

Remedy less than profit

81. Financial service entities have engaged in the offending conduct because it is financially advantageous for them to do so. Any enforcement strategy must ensure that the penalty is commensurate with the gravity of the misconduct being penalised such that entities do not make a 'commercial' decision to engage in conduct despite punitive measures being potentially available for the conduct.

The Interim Report notes that

82. So-called community benefit payments associated with enforceable undertakings appear, at least on their face, to be less than the penalty that ASIC might properly have sought in civil penalty proceedings and unrelated to the profit derived by the entity from the contravening conduct. The regulator *must* do whatever can be done to ensure that breach of the law is not profitable.[8]

Securities and Exchange Commission

83. The evidence from the Royal Commission has revealed most misconduct happens 'out of view'. The Law Council understands the findings of the Interim Report to suggest that enforcement action by ASIC is not coming from a strategic, fundamental understanding of the financial services industry.

84. While ASIC may require additional financial resourcing, the Law Society of New South Wales considers that it may also benefit from adopting the some of the policies and strategic enforcement practices of the United States' Securities and Exchange Commission (**SEC**).

85. The Law Society of New South Wales understands that the SEC employs qualified personnel who have had substantive practical experience of the financial services industry. Senior industry figures are employed for a few years at the SEC before rotating back to industry. Employing key personnel with insider knowledge of the industry may assist the regulator to target appropriate conduct and practices.

ASIC and APRA

86. The Law Society of New South Wales supports the recommendation of the 2014 Financial System Inquiry (**Murray Inquiry**) to improve the regulator accountability

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[6] The Treasury, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission* (December 2015) 120 ('ASIC Capability Review').
[7] Ibid 28 [103].
[8] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) 296.

framework by establishing a Financial Regulator Assessment Board to undertake annual reviews of overall regulator performance against their mandates.[9]

APRA's regulatory and enforcement practices

Recommendations

87. The Law Council notes that:

- APRA's report on the CBA group has prompted significant discussion in the financial sector and beyond, regarding governance, culture and accountability. In our view, this shows early signs of having been effective as a means of shaping corporate conduct; and
- APRA has already commenced a process of requiring risk review self-assessments to be conducted by other prudentially-regulated entities.

88. The Law Council remains concerned that the Banking Executive Accountability Regime (**BEAR**) may operate to the detriment of APRA's effectiveness as a prudential regulator, and the effectiveness of that regime to shape appropriate conduct in the banking sector should be monitored.

Part 7 – Entities: the causes of misconduct

89. The Law Council generally supports the recommendations of the Retail Banking Remuneration Review (**Sedgwick Review**) regarding remuneration and incentive policies.[10]

90. The Law Council acknowledges the intent of the BEAR reforms but remains concerned that they will not achieve their objectives. Extension of that regime may be inevitable – but the Law Council suggests that the effect of the initial reforms be assessed before extensions are introduced.

91. The Law Council considers that greater clarity around the roles of different intermediaries, and whose interests they represent, may reduce the potential for conflict of interest and confusion on the part of consumers and investors.

92. The Law Council is not supportive of regulatory prescription of corporate structures to manage potential conflicts of interest - but notes that it is a matter for Boards to be aware of and take into account.

Responses to conduct risk, the significance of remuneration and BEAR

Recommendations

93. The Law Council endorses the Commission's emphasis on the need to examine remuneration structures and the emphasis on financial measures in remuneration incentives.

[9] Financial System Inquiry, *Final Report* (2014) 235.
[10] Stephen Sedgwick AO, *Retail Banking Remuneration Review: Report* (April 2017).

94. ASIC has signalled increased enforcement activity and targeted surveillance activity. The Law Council supports increased enforcement and notes that in some cases (in particular in relation to governance) the means of surveillance is yet to be assessed.

Further observations

95. Remuneration is a powerful driver of conduct and a signifier of 'what matters'. Balanced scorecard approaches are an improvement but may not be sufficient to offset the emphasis on financial performance.

96. While not disputing that culture must be driven from the top – statements of values or cultural edicts from the Board or senior management, by themselves, will not be effective to shape conduct throughout a large organisation if reward and recognition structures do not align closely with those espoused values.

97. Behavioural science should be factored in, when assessing factors that will shape behaviour, and penalties by themselves may drive the wrong conduct. That is a key concern with the BEAR reforms, in particular.

98. Corporations Act and Listing Rule requirements for listed companies are not necessarily conducive to setting more balanced remuneration packages. In particular – requirements to approve incentive plans, shareholder voting on Remuneration Reports, and the 'two-strikes' rule may have contributed to the problem, given the tendency of shareholders, proxy advisers and representative bodies to focus on financial outcomes ahead of cultural factors when assessing remuneration matters.

Roles of intermediaries and business structures

Recommendations

99. 'Best interests' duties should not be extended to all customer-facing employees or intermediaries. The nature of the role should be assessed and clearly identified, particularly to the customer, as one that is fiduciary in character or not. This may require reforms to the law to reduce the scope of what should properly be described as the provision of financial advice.

100. Corporate groups should be able to sell their own products, and to provide information in relation to their own products – but it may not be appropriate to characterise that as an advisory relationship. The nature of the relationship must be clearly identified to the customer.

101. Where there is a genuine advisory relationship – there must be structures in place to manage conflicts of interest, and that must be reflected in remuneration structures.

102. There is no assurance that prohibiting vertical integration altogether will drive better consumer outcomes. Concerns as to how financial advisory businesses would maintain appropriate quality standards and offer cost effective services are valid.

103. The Commission finds that measures requiring providers to manage the effects of conflict of interest have failed. This area in particular is one in which research shows consumers are frequently unable to rationally assess and act on information provided to them. The Law Council agrees that the view of the conflicts that are capable of management must become more conservative and supports a fundamental rethink of this principle but also notes that some business and personal

conflicts are inevitable and to purport to eliminate them all risks imposing substantial costs on consumers for marginal policy gain.

Further observations

104. Sales functions should be clearly distinguished from advisory functions. The characterisation of sales functions as providing ‘general advice’ has blurred that distinction, and in the Law Council’s view, contributes to the problems considered by the Commission.

105. A relationship should not be construed as an advisory relationship simply because the intermediary provides information about the product being sold – rather it should be clear that it is a sales relationship rather than an advisory relationship.

106. Rules as to misleading and deceptive conduct, and obligations to act honestly, efficiently and fairly, are sufficient to govern communications with customers in a sales context. Product design and distribution reforms will also enhance consumer protections in that context.

107. Conversely, ‘best interests’ obligations should apply in circumstances where an intermediary is acting on behalf of a customer or client, or truly acting as its advisor. There is no justification for an extension of ‘best interests’ duties beyond roles that are truly fiduciary in nature.

Part 8 – Small and medium enterprises

108. Chapter 4 of the Interim Report primarily deals with Australian bank lending to small businesses. The Law Council recognises that there are a range of further fundraising opportunities for small business, including capital raisings and borrowings from entities other than Australian banks, and that the risk requirements of those other entities may differ from those of Australian banks. The following submissions are therefore with regard to Australian banks and the issues raised by the Royal Commission, and not other entities that may be sources of capital and other funding.

109. The Law Council acknowledges the initial issues recognised by the Commission in Chapter 4 of the Interim Report: that there are a number of different definitions of a small business; the differences generally pertaining to the circumstances for which the definition is required; and, that there does not seem to be any appetite or need to replace these differing definitions with one standard definition.

110. The Law Council concurs with the Commission that small business often suffers the same inhibiting issues as do consumers, such as having lack of buying power and resources, limited access to legal and financial advice, as well as business owners understanding of commercial matters being fairly unsophisticated, and there often being an overlap between business and personal assets, particularly in the case of sole traders, where there is not even a legal entity distinction from the individual. In addition, small business loan documents with banks are generally in standard form and there is little opportunity for a small business borrower to require changes.

111. The Interim Report also sets out the current laws that protect small businesses, including the (recently) extended unfair contract terms legislation, unconscionable conduct under the ASIC Act and implied warranty terms of ‘due care and skill’ and ‘reasonably fit for purpose’. The Interim Report then recognises that there does not, from the Royal Commission’s investigations, appear to be any great appetite on the

part of small business to change the current legal position, and the main protection afforded to it is the *Banking Code of Conduct*, to be the revised Banking Code of Practice applicable from 1 July 2019. The Law Council notes, as did the Royal Commission, that the main obligation imposed on banks by the Code, which has been given legal effect, is for a bank when looking at making a loan to 'exercise the care and skill of a diligent and prudent banker', a duty the law would, except for the Code, not otherwise impose.

112. In particular, the Law Council recognises that following the introduction of the extension of unfair contract terms legislation to include small businesses, and with encouragement from the Australian Small Business and Family Enterprise Ombudsman, the major Australian banks have, or are, undertaking an exercise to remove unfair terms from their standard form small business loan documents, and to simplify the drafting of those documents. This exercise will make changes to a number of loan contract terms that were the subject of investigation by the Royal Commission, including the ability of the bank to terminate a loan on non-financial bases.

113. The Law Council notes that the legal relationship between a bank as a lender, and a borrower, including small businesses borrowers, is a contractual relationship that includes both the express terms and conditions of the loan agreement, as well as implied terms and warranties as described above such as implied warranty terms. The Law Council notes that the relationship between a bank lender and a borrower is not a fiduciary relationship and in law there is no consequent obligation on the bank to act in the best interests of the borrower. This is quite a different legal relationship to those of other financial service entities the behaviour of which was also considered by the Royal Commission. Superannuation fund trustees, life insurers, general insurers, trustees of managed investment trusts and, through the Future of Financial Advice (**FOFA**) regime, financial planners, each have either trustee duties or fiduciary duties provided for in legislation, to either act in the best interests of their customers (superfund members, investors in managed investment trusts), to prefer the interests of the customer (policyholder) where the interest of the policyholder and of the entity's shareholders conflict (life insurance), or to act with regard to the policyholder in utmost good faith (general and life insurers) – noting the comments in parts 6 and 7 above as to when the best interests obligation should apply.

114. The Law Council submits that it is essential for the Royal Commission to appreciate this major difference in the legal relationship when the Commission considers issues involving the interaction of banks as lenders with borrowers, and also particularly when the Commission considers opportunities to seek to alter the culture of those working in banks, who are used to acting only in the interests of the bank under contract law.

115. Given that the Interim Report takes the position that it is not preferable to introduce further legislation/regulation to seek to influence the behaviour and culture of banks, a position the Law Council agrees with, the Committee considers and submits that the terms of The Banking Code of Practice could be the most opportune place to have banks recognise that it is in their interests from a reputational perspective, to consider the interests of borrowers when making loans, particularly to consumers and small businesses who are unable, due to the recognised power imbalance, to negotiate changes in standard form loan documents.

116. The Law Council has sought to respond below to each of the questions listed in the Proposals Paper.

Code of Banking Practice (Code)

What inquiries should a diligent and prudent banker make when deciding whether to lend to an SME?

117. In the Law Council's view a diligent and prudent banker would need to make inquiries of a potential borrower to satisfy itself that the borrower should be able to service the debt and repay the loan when it becomes due and payable, both if the business continues as a going concern, or if it suffers financial stress, but without the loan and its terms and conditions causing financial stress to the borrower.

Does 'forming an opinion about the customer's ability to repay the loan facility' as required by Clause 51 of the 2019 Code involve bringing critical analysis to the cash flow forecasts and other business plan documents presented by customers?

118. The Law Council notes that clause 51 of the Code states that when assessing whether a small business can repay a loan, the bank will do so by 'considering the appropriate circumstances known to' it about: (a) the small business's financial position; or (b) the small business's conduct, and where reasonable to do so may rely on resources of third parties available to the small business.

119. Consequently, the Code only requires the bank to look at the accounts of the small business (to consider its financial position), or, not 'and', to look at how the small business has conducted its account (for example, making regular deposits, not going into overdraft or building up an account balance).

120. The Code does not provide for the bank to look at and analyse a small business's business plan documents or cash flow forecasts. The Code then allows the bank, when it's reasonable to do so, to rely on third party resources connected with and available to the small business, to support its assessment of the small business's ability to repay the loan (e.g. by taking a guarantee or security by way of mortgage over an asset owned by the third party).

121. Despite the Code not requiring the bank to consider business plan documents and cash flow forecasts when assessing a small business borrower's ability to repay the loan, the Law Council considers that the bank should also assess the borrower's ability to service the debt, which is illustrated by business plan documents and cash flow forecasts.

122. The Law Council agrees that 'forming an opinion about the customer's ability to repay the loan facility' as required by Clause 51 of the 2019 Code, although it currently does not, should involve bringing critical analysis to the cash flow forecasts and other business plan documents presented by customers.

123. It should be a basic requirement of an application by an SME to borrow money that a diligent and prudent banker as a lender would need to assess the ability of the borrower to service the debt and to repay the loan when due. Likewise, it should be a basic requirement of a potential borrower, including an SME borrower, for it to have planned for and understand that it has the ability to do so.

124. From the SME Committee's experience, SME borrowers benefit from understanding their obligations and ability to service their borrowings and to repay their loans. In accordance with good business practices, an SME should be able to provide a proposed lender with business plan documents to support the viability of the business they are conducting, including cash flow forecasts. The business plan and cash forecasts should demonstrate the SME borrower's ability to service the debt.

125. The ability of a business to repay the loan may depend on the purpose of the loan, the value of, which to the business should also be illustrated in business plan documents. For example, if the loan is taken to enable the business to set up additional operations which, once established, will provide an increased profitable income source, the business could be expected to be able to repay the loan from those additional profits.

126. Consequently, analysing the potential of the business to service its borrowings and repay its loan as supported by the illustrated financial information about the business in business plan documents and cash flow forecasts should be an essential element in the lender's assessment of its willingness to lend to the borrower.

If so, what level of analysis is acceptable?

127. A lender needs to ensure that the borrower can service the debt from forecast cash flows without incurring financial stress that might cause the borrower to be unable to conduct its business, such as not being able to pay business creditors and employee entitlements when due. SME borrowers, particularly if they are sole traders, may also have personal payment requirements that also need to be able to continue to be made.

128. The Law Council considers that a potential lender to an SME should therefore be comfortable that the SME will be able to service its debt and repay the loan without causing such financial stress, including in scenarios over the period of the loan when market conditions, particularly the interest rate to be charged by the lender, may increase.

Is it enough that the lender satisfy itself the borrower can repay the loan and that the business plan is not obviously flawed?

129. From the experience of the SME Committee, it should be sufficient for the lender to provide a loan to an SME borrower if the lender is able, following such acceptable analysis of the SME borrower's financial position, business plan and cash flow forecast, to be satisfied that the borrower can service the debt and repay the loan.

Is the standard set out in Clause 51 of the 2019 Code, which requires a bank to determine whether a customer can repay a loan based on their financial position and account conduct, a sufficient standard?

130. The Law Council does not consider the standard currently set out in clause 51 of the Code to be sufficient as it does require the bank to consider the business plan documents and cash flow forecasts of the small business looking to borrow and does not cater for an assessment by the bank of a small business borrower's ability to service the loan. The Law Council notes that the current standard focuses on the ability of the small business to repay the loan, and caters for the bank to protect its position by, when it is reasonable to do so, relying on resources of third parties for loan repayment.

131. Expressing an alternative perspective, the Law Society of New South Wales submits that:

- There are significant instances of conduct identified and criticised in the Interim Report that occurred because the relevant bank did not comply with the banking industry code of practice as it stood at the relevant time. The most notable of these instances concerned lending to SMEs and lending to agricultural enterprises.

- Contravention of a provision of the current Code or of a provision of the 2019 Code may be a breach of contract but otherwise is not otherwise a contravention of law. The Law Society of New South Wales suggests that the Royal Commission seriously consider whether the Code should be subject to Part IVB of the *Competition and Consumer Act 2010* (Cth) (sections 51ACA–51AEA), to bring it into line with similar industry codes of practice that are dealt with under that Part.
- Making the promises made in the Code enforceable, as contraventions of the law, may, in the view of the Law Society of New South Wales, provide better protection for SMEs and agricultural enterprises, among other customers. Approval of a code by ASIC will allow ASIC to determine for itself whether the terms proposed are complete and satisfactory.

Guarantee

If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced?

132. In the Law Council's view, if established principles of case law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, the guarantee should be enforceable. It would be a very rare and exceptional case, if there be such a case, where this outcome ought not ensue.

133. The reason the bank takes a guarantee is to protect its ability as the lender to receive repayment from the guarantor of the loan should the borrower not be able to repay the loan. The provision of a guarantee by a borrower is a long- established practice. It allows banks to make loans to borrowers who they might otherwise not lend to, or might only lend to at a higher interest rate to reflect the higher risk being taken on by the bank. The provision of a guarantee should enable the bank to assess the borrower as not being a higher risk borrower potentially unable to repay the loan.

What would those circumstances be?

134. The Law Council does not consider there should be any other circumstances if the bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached.

Would they be defined by reference to what the lender did or did not do, by reference to what the guarantor was or was not told or by reference to some combination of factors of those kinds?

135. The case law, and statutory provisions about unconscionability, that can currently operate to relieve a guarantor of responsibility under a guarantee, already apply by reference to what the lender did or did not do, by reference to what the guarantor

was or was not told and the extent to which it was understood or by reference to some combination of factors of those kinds.

Is there a reason to shift the boundaries of established principles, existing law and the industry code of conduct?

136. The SME Committee does not consider there is any reason with regard to the application of guarantees provided to support loans to shift the boundaries of established principles, existing law and the industry code of conduct.

If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an enforceable undertaking?

137. In the Law Council's view, if the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, and has agreed to provide the guarantee, there need not be any additional requirement that must be shown to have been met before the guarantee was given and the guarantee should be enforceable.

Should lenders give potential guarantors more information about the borrower or the proposed loan? What information could be given with respect to a new business?

138. The Law Council recognises that lenders, particularly banks, will require a guarantor to have received independent legal advice or to have waived the need to do so. In some jurisdictions (New South Wales and Victoria) the lawyer may be required by the lender to certify that such advice has been provided. These requirements arose following legal cases that operated to relieve the guarantor of responsibility under the guarantee because the guarantor had not understood or been apprised of their obligations.

139. As a consequence, the Law Council takes the position that there should be no need for potential guarantors to be given any further information about the borrower or the proposed loan, even with regard to a new business. In practice, a borrower would normally request a guarantee from a person or entity they have a relationship with. The borrower should provide the proposed guarantor with sufficient information to allow the guarantor to decide, after also having received independent legal advice or having waived the need to do so, to become guarantor.

External dispute resolution

Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused?

140. The Law Council notes that Financial Ombudsman Service's (**FOS**) approach of putting the borrower back into the position they would have been in had the loan not been made appears to be intended to align with the equitable remedies awarded for breach of obligations by fiduciaries and trustees. The Australian Financial Complaints Authority (**AFCA**), however, when dealing with complaints against banks, should recognise that at this point banks do not have fiduciary obligations to their borrowers; rather the relationship between a bank as the lender and a borrower is contractual.

141. The Law Council believes that, as in any other matter when one party suffers damages due to the other party breaching its contractual obligations, whether express or implied, the party who suffers damages should be entitled to be compensated. Given loans from banks are contracts, the Law Council considers the bank lender should compensate a borrower for any direct damages suffered by the borrower.

142. The Law Institute of Victoria notes that it is recognised that by the creation of the new external dispute resolution scheme the AFCA, consumers of financial services now have an additional avenue for redress in relation to disputes arising as a result of misconduct by financial service providers. It is submitted that the AFCA should be provided with greater powers to award damages to fully compensate consumers and if possible, avoid loan repayments in appropriately serious instances of misconduct.

Are there circumstances in which AFCA should waive a customer's debt?

143. The Law Council considers that should the damages suffered by a borrower due to the lender bank's breach of its contractual obligations, whether express or implied, be equivalent to the value of the loan, it would be appropriate for AFCA to waive the customer's debt.

Part 9 – Contact

144. The Law Council would be pleased to discuss, or expand on, any aspect of this submission. Please contact Dr Natasha Molt, Director of Policy, Policy Division (02 6246 3754 or at natasha.molt@lawcouncil.asn.au) in the first instance.