ASIC

Australian Securities & Investments Commission

REPORT 565

Unfair contract terms and small business loans

March 2018

About this report

This report details the changes made by the ‘big four’ banks to their small business loan contracts, in order to comply with the unfair contract terms law.

This report will also be relevant for other lenders who provide loans to small business and assist them in meeting their obligations.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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Executive summary

Small business contracts and unfair contract terms

1 Small businesses, like consumers, are often offered contracts for financial products and services on a 'take it or leave it' basis, commonly entering into contracts where they have limited or no opportunity to negotiate the terms. These are known as 'standard form' contracts.

2 With effect from 12 November 2016, the unfair contract terms provisions applying to consumers under the Australian Consumer Law were extended to cover standard form small business contracts. For loan contracts, the new laws generally cover small business loans of up to $1 million.

Note: In this report, we refer to these provisions as the 'unfair contract terms law'. ASIC is responsible for enforcing the unfair contract terms law in relation to financial products and services: see Div 2 of Pt 2 subdiv BA of the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

3 The unfair contract terms law protects small businesses in all sectors of the economy, not just in the financial services sector. For example, the Australian Competition and Consumer Commission (ACCC) published a report to outline the common terms of concern that it found in its review of small business contracts across different industries (e.g. advertising and telecommunications), and to discuss the types of changes that businesses made: see ACCC, *Unfair terms in small business contracts: A review of selected industries* (November 2016).

4 Following the commencement of the unfair contract terms law, ASIC and the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) conducted a review of small business loan contracts offered by the big four banks. ASIC and the ASBFEO were concerned that the banks had not done enough to bring their small business loan contracts into compliance with the law. In August 2017, ASIC and the ASBFEO announced the changes being made by the banks to address our concerns.

Note: In this report, we refer to the big four banks as 'the banks'.

5 This report:

(a) provides more detailed information about the changes made by the banks to their small business loan contracts to reduce the risk of non-compliance with the unfair contract terms law; and

(b) outlines the types of terms that raise concerns under the unfair contract terms law that other lenders to small business customers should consider when they assess whether they need to make any changes to their small business loan contracts to comply with the law.

Note: For more information on how the unfair contracts law applies to small business contracts for financial products and services, see Information Sheet 211 *Unfair contract term protections for small businesses* (INFO 211).

Changes to small business loan contracts

6 Following intervention by ASIC and the ASBFEO, the banks have made the changes set out in Table 1, which will apply to all small business loan contracts entered into or renewed from 12 November 2016 (i.e. when the unfair contract terms law applied to small business contracts).

Table 1: Summary of changes to small business loan contracts

Issue	Changes made by the banks
Entire agreement clauses	Clauses that prevent lenders from being held contractually responsible for conduct, statements or representations made to small business borrowers outside the written contract are likely to be unfair. Three banks did not have entire agreement clauses in their small business loan contracts; one bank removed the clause from its small business loan contracts. The banks have confirmed that their small business loan contracts now do not contain clauses that have this effect or the clauses will no longer be applied to their small business loan contracts. This means that statements by bank staff about, for example, how the loan contract operates may form part of the contract subject to normal legal principles.
Broad indemnification clauses	Clauses that require borrowers to cover losses, costs and expenses incurred due to the fraud, negligence or wilful misconduct of the bank, its employees or agents or a receiver appointed by the bank are likely to be unfair. The banks have confirmed that any clauses that have this effect have been removed or the clauses will no longer be applied to their small business loan contracts. This means that borrowers will not be responsible for costs incurred due to the fraud, negligence or wilful misconduct of people or entities who are outside the borrower's control or who act on the instructions of the lender.
Event of default clauses	*Material adverse change events of default*—Clauses that allow lenders to treat a loan as being in default because of any unspecified 'material adverse change' are likely to be unfair. These clauses gave the banks a very broad discretion to call a default against the borrower without giving the borrower any clarity about what types of change could result in a default. The banks have confirmed that these clauses have been removed or will no longer be applied to their small business loan contracts. *Specific events of non-monetary default*—The banks have also considerably limited the specific events of default listed in the loan contract that could allow the bank to call a default (other than for non-payment) and terminate a loan contract with the small business borrower (e.g. a misrepresentation made by the borrower to the lender): see Table 2 in the appendix for details. The wording of these specific events may still be broad enough for an event to trigger a disproportionate enforcement action by the lender. For example, even though 'misrepresentation' is listed in small business loan contracts as a specific event of default, if a minor misrepresentation by the borrower such as an incorrect date of birth, led to a default and enforcement under the loan contract, this could be a disproportionate enforcement action. To deal with the potential for a disproportionate effect, lenders should: • provide a reasonable period for a borrower to remediate a breach of a specific event; and • adopt a materiality threshold so that a breach of a specific event must create a material risk to the lender of monetary default, or of being unable to enforce its rights against any secured property, before it can take enforcement action.

Issue	Changes made by the banks
Financial indicator covenants	The use of a breach of some financial indicator covenants such as loan-to-valuation ratio (LVR) in small business loans to trigger a default and enforcement of the loan could be unfair where a breach of a particular covenant by a small business borrower does not present a material credit risk to the lender. In these cases, a term entitling the lender to call a default based on a breach of the covenant is likely to create an imbalance in rights and obligations of the parties that would cause detriment to the borrower and is not reasonably necessary to protect the legitimate interests of the lender. Some banks have limited the use of financial indicator covenants by: • removing financial indicator covenants (e.g. LVR) as triggers for default for most small business loans except for specialised loans such as property development, margin lending and foreign currency loans; and • removing financial indicator covenants for property investment loans. The banks have also limited the impact or consequences of some of these breaches of financial indicator covenants on borrowers: • two banks agreed that where there was a breach of a financial indicator covenant, they would not call a default unless that breach creates a material credit risk for the bank; and • one bank agreed to treat a breach of covenant in cash flow lending as a review event (and not a default event), entitling the bank to take other action but not an enforcement action. We encourage other lenders to adopt a similar approach.
Unilateral variation clauses	Clauses that give lenders a broad ability to vary contracts without agreement from the small business borrower have a high risk of being unfair as they cause a significant imbalance in the rights of the lender and small business borrower (in favour of the lender) and are unlikely to be reasonably necessary to protect the legitimate interests of the lender if they can be used in a broad range of circumstances to make a broad range of variations to the contract. The banks have limited their variation clauses to specific defined circumstances set out in the contract (e.g. interest rate changes). Where such a variation would cause the borrower to want to exit the contract by repaying or refinancing, the banks will now provide a period of between 30 and 90 calendar days for the borrower to do so before the variation takes effect.

Next steps

7 The banks will use multiple channels to advise small business borrowers about the changes, including directly contacting all relevant small business borrowers who entered into or renewed a loan from 12 November 2016.

8 ASIC will monitor the banks' use of the changed clauses, particularly those relating to financial indicator covenants, variations and specific events of non-monetary default to ensure that they are being applied as agreed and are not relied on by the banks in a way that is unfair to small business customers.

9 We will also undertake further work to examine small business loan contracts from other lenders to ensure that these contracts do not contain unfair terms.

A Small business contracts and unfair contract terms

Key points

The unfair contract terms law applies to standard form small business contracts entered into, or renewed, on or after 12 November 2016, where the upfront price payable does not exceed $1 million if the contract is for longer than 12 months.

A term in a standard form small business contract is 'unfair' if:

- it would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- the term is not reasonably necessary to protect the legitimate interests of the party that would benefit from its inclusion; and
- the term would cause financial or other detriment (e.g. delay) to a small business if it were to be applied or relied on.

Which contracts are covered?

10 Small businesses commonly enter into 'standard form' contracts for financial products and services, including business loans, credit cards and client or broker agreements.

11 The unfair contracts law applies to standard form small business contracts entered into, or renewed, on or after 12 November 2016, where:

(a) the contract is for the supply of financial goods or services (this includes a loan contract);

(b) at least one of the parties is a 'small business' (i.e. a business employing fewer than 20 people, including casual staff employed on a regular and systematic basis); and

(c) the upfront price payable under the contract does not exceed $300,000, or $1 million if the contract is for more than 12 months. Most small business loan contracts are for periods of more than 12 months, so the monetary limit is generally $1 million.

Note: For the purposes of subparagraph 11(c), any interest payable on the loan is excluded from the upfront price payable.

12 The unfair contract term law applies to these contracts as follows:

(a) If a term of a contract is varied on or after 12 November 2016, the law applies to the varied term but not to the rest of the contract.

(b) If a contract is automatically renewed (i.e. 'rolled over') on or after 12 November 2016, the law applies from the renewal date.

(c) If a contract is rolled over on a periodic basis (e.g. month-to-month), the law applies from the first new period starting on or after 12 November 2016.

13 Small business contracts that are covered by an industry code, such as the Code of Banking Practice administered by the Australian Bankers' Association (ABA) or the Customer Owned Banking Code of Practice, may also have other protections, including protections that are similar to those provided under the unfair contract terms law.

When is a term of a small business contract unfair?

14 A term in a standard form small business contract is 'unfair' if:

(a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract;

(b) the term is not reasonably necessary to protect the legitimate interests of the party that would benefit from its inclusion; and

(c) the term would cause financial or other detriment (e.g. delay) to a small business if it were to be applied or relied on.

15 In determining whether a term of a contract is unfair, the following factors are also relevant:

(a) the extent to which the term is transparent; and

(b) the contract as a whole.

16 A term is considered to be 'transparent' if it is:

(a) legible;

(b) expressed in reasonably plain language;

(c) presented clearly; and

(d) readily available to any party affected by the term.

17 If a court finds that a term in a standard form contract is unfair, it makes a declaration to that effect and the term is void (i.e. as if it never existed): see s12GND and 12BF of the ASIC Act, respectively. The term is void from the outset, not from the time of the court's declaration and the term is likely to be unfair and void in all identical contracts (although in some cases, the circumstances of a particular customer may affect a finding of unfairness for that particular contract). The remainder of the contract will continue to bind parties if it can operate without the unfair term.

Note: See *Australian Competition and Consumer Commission v Chrisco Hampers Australia Ltd* (2015) 239 FCR 33 where the court declared a term void in all identical contracts.

18 If a person has acted in reliance on a contractual term which is later declared to be unfair and hence void, that person may have acted without legal authority and be subject to common law claims for damages. For example, the person may be liable in tort in relation to trespass on land or for taking

possession of property without a valid contractual entitlement to do so. Alternatively, the person may be liable for breach of contract because the contractual exception or defence they relied on is void, or the person may have to repay money which they had no valid contractual entitlement to keep.

19 If a court declares a term to be unfair and the term is likely to cause a class of persons who were not parties to the proceedings to suffer loss or damage, ASIC may seek an order to compensate non-parties in the same or later proceedings. The court may make such orders as it thinks appropriate against the party advantaged by the term—for example, to redress, prevent or reduce loss or damage to non-parties: see s12GNB and 12GNC of the ASIC Act.

20 The orders the court can make include orders:

(a) declaring all or part of a contract to be void;

(b) varying a contract;

(c) refusing to enforce some or all of the terms of a contract or arrangement;

(d) directing a party to refund money or return property to the small business affected; and

(e) directing a party to provide services to the small business affected at the party's expense.

21 In addition, if a court has declared that a term is unfair and a party subsequently seeks to apply or rely on the unfair term (including in an identical contract with another party), this will be treated as a contravention of the ASIC Act: see s12GD and 12GM. The remedies available for such a contravention include:

(a) an injunction;

(b) an order to provide compensation or prevent injury to any small business affected by the contravention that applies for an order (or on whose behalf ASIC applies for an order); and

(c) any other orders the court considers appropriate.

What is ASIC's role?

22 Since 1 July 2010, ASIC has administered the law to deal with unfair terms in standard form consumer contracts for financial products and services including loans. From 12 November 2016, the unfair contract terms law was extended to cover standard form small business contracts with the same protections provided to consumers.

23 ASIC deals with the unfair contract terms law in relation to financial products and services. For other goods and services, enforcement of the unfair contract terms law is shared between the ACCC and the state and territory consumer protection agencies.

24 Generally, we do not take action on behalf of individual consumers or businesses. For small businesses, there are a number of options available to enforce their rights, including:

(a) making a complaint directly to the lender;

(b) if the lender is unable to resolve the issue, making a complaint to the financial services provider's external dispute resolution scheme (e.g. the Financial Ombudsman Service or the Credit and Investments Ombudsman); and

(c) taking court action against the lender.

Work done by ASIC and ASBFEO

25 In February 2017, the ASBFEO released a report to outline the findings and recommendations of its inquiry into small business loans: see ASBFEO, *Inquiry into small business loans* (February 2017).

26 In March 2017, ASIC and the ASBFEO found that eight lenders, including the banks, had failed to take sufficient steps to comply with their obligations under the unfair contract terms law after a review into their standard form small business loan contracts: see Media Release (17-056MR) *ASIC and ASBFEO join forces to ensure bank lenders meet unfair contract laws* (9 March 2017).

27 In May 2017, the banks committed to make a series of major changes on a range of issues identified by ASIC and the ASBFEO to make it more likely that all small business loans entered into or renewed from 12 November 2016 will comply with the unfair contract terms law. This commitment followed a roundtable discussion hosted by ASIC and ASBFEO: see Media Release (17-139MR) *ASIC and ASBFEO hold banks to account on unfair contract terms* (16 May 2017).

28 We continued to work with the banks on the detail of the necessary changes and in August 2017, ASIC and the ASBFEO announced that the changes agreed to by the banks significantly reduce the risk of unfair contract terms in their small business loan contracts: see Media Release (17-278MR) *Big four banks change loan contracts to eliminate unfair terms* (24 August 2017).

B Changes to small business loan contracts

Key points

For small business loan contracts of up to $1 million, the banks have:

- ensured that the contract does not contain ‘entire agreement clauses’ which prevent statements by bank officers (e.g. about how bank discretions will be exercised) from forming part of the contract;
- limited the operation of broad indemnification clauses;
- addressed concerns about event of default clauses, including ‘material adverse change’ events of default and specific events of non-monetary default (e.g. misrepresentations by the borrower);
- limited the circumstances in which financial indicator covenants will be used in small business loans and when breach of a covenant will be considered an event of default; and
- limited their ability to unilaterally vary contracts to specific circumstances with appropriate advance notice.

The changes by the banks will apply to all relevant small business loan contracts entered into or renewed from 12 November 2016 (i.e. when the unfair contract terms law applied to small business contracts).

Entire agreement clauses

29 ‘Entire agreement’ clauses typically state that the contract, as agreed to by the parties, represents all of the rights and obligations between the parties (i.e. the contract document represents the ‘entire agreement’).

30 ASIC was concerned that entire agreement clauses or similar terms in small business loan contracts may be unfair as they could absolve the lender from any contractual responsibility for conduct, statements or representations that the lender’s staff may have made to small business borrowers about how the contract would operate (e.g. how the bank would exercise its discretions during or on review of the loan).

31 Three banks did not have entire agreement clauses in their small business loan contracts; one bank removed the entire agreement clause from its small business loan contracts. The banks have confirmed that their small business loan contracts now do not contain entire agreement clauses or similar terms, or the clauses will no longer be applied to their small business loan contracts.

Risk for lenders: Entire agreement clauses

The risk of non-compliance with the unfair contract terms law is likely to be high if small business loan contracts contain any terms that seek to absolve the lender from contractual responsibility for conduct, statements or representations they make to borrowers about the contract.

Broad indemnification clauses

32 Broad indemnification clauses in small business loan contracts are terms that make the borrower liable to the lender for losses, costs, liabilities and expenses suffered or incurred by the lender, including those that may arise outside the control of the small business borrower.

33 ASIC was concerned that broad indemnification clauses that impose an obligation on a small business borrower to indemnify the lender for losses, costs, liabilities and expenses caused by fraud, negligence or wilful misconduct of the *lender* (including its employees, contractors and agents and appointed receivers) are likely to create an imbalance in rights and obligations of the parties which would cause detriment to the borrower and are not reasonably necessary to protect the legitimate interests of the lender.

34 Although receivers are often appointed under security documents as the borrower's agent in law, in practice they are chosen by the lender, act in the lender's interests to recover value and act on the instructions of the lender. It is the lender not the borrower who can take steps to manage and mitigate the risk of fraud, negligence or wilful misconduct by the receiver and it is not fair for the borrower to indemnify the lender for consequences of such conduct.

35 In *Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224 (*ACCC v JJ Richards*), the court declared unfair and void a broad indemnification clause which required the small business customer to indemnify JJ Richards (a waste management service provider) for all liabilities, claims, damages, actions, costs and expenses which may be incurred by JJ Richards as a result of or arising out of or otherwise in connection with the agreement.

36 The court found that the broad indemnification clause created a significant imbalance in rights and obligations of the parties because it created an unlimited indemnity in favour of JJ Richards, even where the loss incurred by JJ Richards is not the fault of the small business customer or could have been avoided or mitigated by JJ Richards: see *ACCC v JJ Richards* at [56].

37 In *Australian Competition and Consumer Commission v ByteCard Pty Limited* 301 FCA 2013 (*ACCC v ByteCard)*, the Federal Court found that, in a consent judgment about a consumer standard form contract with an internet service provider, an indemnity was unfair and void because it required the consumer to indemnify the internet service provider even where the liability loss or damage may have been caused by the internet service provider.

38 The banks have confirmed that their indemnification clauses will not require a small business borrower to reimburse the lender for any losses, costs, expenses and liabilities which arise from the fraud, negligence or wilful misconduct of:

(a) the lender;

(b) the lender's officers, employees, contractors or agents; or

(c) any receivers appointed by the lender over the secured property.

Risk for lenders: Broad indemnification clauses

The risk of non-compliance with the unfair contract terms law is likely to be high if a clause requires a small business borrower to reimburse the lender for losses, costs, expenses and liabilities incurred by the lender arising from the fraud, negligence or wilful misconduct of:

- the lender; or
- the lender's officers, employees, contractors or agents; or
- any receivers appointed by the lender over the secured property.

Events of default clauses

General considerations

39 Events of default clauses describe the events or circumstances which constitute a default by the borrower and which entitle the lender to apply default consequences (such as a higher default interest rate). Typically there are many events of default specified in a loan contract. The most obvious is a failure by the borrower to pay an amount of principal or interest or other payment when due (i.e. a *monetary* default).

40 Others are *non-monetary* events (i.e. not based on a failure to pay money to the lender) which may present a change in credit risk to the lender. Non-monetary events of default can include a misrepresentation by the borrower, a failure to maintain insurance, a breach of a covenant, an unauthorised use of the borrowed funds or a change in control of the borrower company.

41 Often non-monetary events of default are described at a high level of generality. They can encompass circumstances that create a significant credit risk for the lender (e.g. a misrepresentation that significantly overstates the borrower's preceding two years' of income or the value of their assets) and can also include circumstances that do not expose the lender to significant credit risk (e.g. a minor misrepresentation about the borrower's place of birth).

42 The effect is to give lenders a broad discretion about whether to treat a particular event or circumstance within the general description of an event of default as an actual default. A material adverse change event of default clause gives extremely wide discretion to the lender—if the lender considers that *any* change in circumstances is materially adverse, it can call a default.

43 Typically, loan contracts also give lenders a broad discretion about the consequences that can be imposed for a default. These consequences may include one or more of the following:

(a) applying default interest rates;

(b) stopping further drawdowns;

(c) appointing investigating accountants to report on the business;

(d) reducing the size of the loan and requiring repayment of some principal;

(e) changing the repayment terms (e.g. to increase the size and frequency of repayments);

(f) requiring immediate repayment of all principal and interest; and/or

(g) enforcing guarantees and securities, including by appointing a receiver and manager over the business, and selling the business and secured property.

44 It is common for the terms of the loan contract to give the lender a broad discretion about whether to call a default (because events of default are defined very broadly) with a broad discretion about what consequences to impose if a default is called. A lender may choose to exercise such broad discretion even where it has not been exposed to significant credit risk because of other commercial drivers (i.e. for reasons that are not directly related to the specific small business borrower that may have technically triggered an event of default).

45 For example, the ASBFEO found that non-monetary default clauses allow lenders to trigger a default where risk factors may have changed, even when the small business borrower has continued to meet their regular repayments. It also found that while lenders use these clauses to limit their risk, they often confer broad and unilateral power to recoup funds lent or vary loan terms and conditions: see ASBFEO's Small Business Loans Inquiry at p. 28.

46 These combined discretions present a significant risk of the terms being unfair because they empower the lender to respond to an event in a way which is significantly disproportionate to the credit or other risk to the lender created by the event. The terms are likely to be unfair if the combined broad discretions are not reasonably necessary to protect the legitimate interests of the lender.

47 In response to ASIC's concerns, the banks have limited these two discretions under their terms to more precisely specify events of default which presented a credit risk to the lender and to ensure that the consequences imposed by the lender were not significantly disproportionate to that risk.

Material adverse change events of default

48 Clauses in small business loan contracts about material adverse change events of default allow lenders to apply default consequences to the loan for an unspecified negative change in the borrower's circumstances, even if the borrower is meeting their financial obligations in full and on time under the contract.

49 These clauses can be very broad and are likely to be unfair to the borrower where:

(a) the adverse event did not represent a material risk to the lender of a monetary default or of the lender being unable to enforce its rights against the secured property; or

(b) the contractual response of the bank to the event was not reasonable or proportionate to the increased risk to the bank and the lender terminated the loan and accelerated repayment of loan amount.

50 The banks have confirmed that material adverse change event clauses have been removed or will no longer be applied to their small business loan contracts.

Risk for lenders: Material adverse change events of default

The risk of non-compliance with the unfair contract terms law is likely to be high if lenders have clauses about material adverse change events of default and similar terms that allow lenders to terminate the loan for an unspecified negative change in the small business borrower's circumstances.

Specific events of non-monetary default

51 As part of the ABA's response to the ASBFEO's Small Business Loans Inquiry, the banks have agreed to limit specific events of non-monetary default resulting in enforcement action to the following events:

(a) unlawful behaviour;

(b) insolvency, bankruptcy and administration;

(c) other creditor enforcement;

(d) misrepresentation;

(e) use of the loan for non-approved purposes;

(f) dealing with loan security property improperly or without consent;

(g) change of beneficial ownership of company (except as permitted);

(h) loss of licence or permit to conduct business;

(i) failure to provide proper accounts; and

(j) failure to maintain insurance.

Note: The ABA's original list of six events has been re-categorised into ten events.

52 In ASIC's view, a risk remains that the wording of these events is still broad enough for an event to be used to trigger a disproportionate enforcement action by the lender. For example, it would be unfair to a small business borrower if a minor and inconsequential misrepresentation by the borrower (e.g. an incorrect place of birth) led to a default under the loan contract, even though 'misrepresentation' is a specific event of default in the ABA's list.

53 We consider that lenders should:

(a) provide a reasonable period for a borrower to remediate a breach of a specific event (if it is remediable); and

(b) adopt a materiality threshold so that a breach of a specific event must create a material risk to the lender of a monetary default or of the lender being unable to enforce its rights against any secured property.

Note: This could be done by incorporating a credit risk-related materiality element into the definitions of the specific events, or applying a separate material credit risk test before enforcement action is taken based on the event occurring.

54 Based on our discussions with the banks, it seems clear that:

(a) insolvency, bankruptcy and administration events cannot be remediated by the borrower and would automatically meet a materiality threshold;

(b) for a failure to provide proper accounts, a materiality threshold cannot be applied without receiving the relevant accounts that must be submitted by the borrower; and

(c) for an unlawful behaviour event, an event that poses a material risk to the bank's reputation or the bank's own compliance with the law may justify calling a default even if the event did not present a material credit risk.

55 The banks have each taken a slightly different approach to:

(a) whether specific events are remediable; and

(b) how to adopt a material credit risk threshold, by either including a credit risk-related materiality element in the definitions of specific events and/or by applying a separate material credit risk test before enforcement action is taken based on the event occurring.

Note: See Table 2 in the appendix for a summary of the banks' approach to specific events of non-monetary default.

56 We have also observed that some banks include a term in their general business loan contracts that any breach of any other agreement with the bank (e.g. a guarantee or security agreement to support the loan contract or a separate financing agreement) will constitute a breach of that contract (sometimes called a 'cross-default' clause). We expect that cross-default clauses should not operate in a way that is inconsistent with the commitments made by the banks limiting the permissible non-monetary events of default in the loan contract.

57 In other words, we expect that the banks will not be entitled to call a default under a small business loan contract because a non-monetary event of default has occurred under a separate security agreement or separate financing agreement if that default did not meet the bank's commitments about the types of non-monetary defaults that can be included in the small business loan contract (i.e. the non-monetary default event under the other agreement was not within the agreed list of specific events of non-monetary default). Otherwise, there is a risk that a cross-default clause in a small business loan contract may be an unfair contract term.

58 Banks could achieve this outcome by, for example:

(a) specifying that the cross-default clause in the small business loan contract could not trigger a default under that contract unless the non-monetary event of default in the other agreement was included in the agreed list of permissible non-monetary events of default for small business loan contracts; or

(b) ensuring the non-monetary events of default in the other agreement fall within the agreed list of permissible non-monetary events of default for small business loan contracts.

59 Three banks have restricted the use of cross-default by ensuring that the non-monetary events of default in their security agreement and/or other finance agreements will be limited to the list of permissible non-monetary events of default in the small business loan contract.

60 One bank in our review previously included in its list of default events for its general small business loan contract, a broadly-worded cross-default clause that gave the bank the power to call a default under the small business loan contract because of any event of default under a separate security agreement or financing agreement.

61 After we raised concerns about the extent of the broadly-worded cross-default clause, the bank agreed that it will revise its use of the clause so that the cross-default clause in the small business loan contract cannot trigger a default under the loan contract unless the non-monetary default event under the other agreement is included in the agreed list of permissible non-monetary events of default for small business loan contracts.

62 We will monitor the use by the banks of clauses relating to specific events of non-monetary default to ensure they are not being applied inappropriately or unfairly to small business loans. In particular, we will examine the banks' use of:

(a) specific events of non-monetary default to ensure disproportionate enforcement actions are not being taken in response to a breach of an event; and

(b) cross-default clauses to ensure that the clauses are not used in a way that is inconsistent with the banks' commitment to limit specific events of non-monetary default in small business loan contracts.

Risk for lenders: Specific events of non-monetary default

The risk of non-compliance with the unfair contract terms law is likely to be high if lenders do not:

- provide a reasonable period for a borrower to remediate a remediable breach of a specific event;

- adopt a materiality threshold (e.g. by incorporating a credit risk-related materiality element into the definitions of the specific events, or applying a separate materiality credit risk test); and
- limit cross-default clauses so that they operate in a way which is consistent with the commitments made by the banks to restrict the permissible non-monetary events of default in the loan contract.

Financial indicator covenants

63 In general, a financial indicator covenant in a small business loan is a condition about the financial position or operations of the business (typically in the form of a ratio) that the small business borrower must meet.

64 For example, a covenant may specify:

(a) the proportion of monthly income earned to the amount of monthly interest owed that must be met (known as an 'interest cover ratio'); or

(b) the ratio of the value of the loan to the value of the secured property that the loan cannot fall below (the 'loan to valuation ratio' or LVR).

65 ASIC was concerned that the use of some covenants in small business loans as triggers for default and enforcement could be unfair where a breach of a particular covenant by a small business borrower does not present a material credit risk to the lender. In these cases, a term providing that any breach of the covenant is or can be a default is likely to create an imbalance in rights and obligations of the parties which would cause detriment to the borrower and is not reasonably necessary to protect the legitimate interests of the lender.

66 We acknowledge that most financial indicator covenants are useful monitors of the financial performance of the borrower's business and the value of the security for some products, particularly where the value of the asset which supports the loan can fluctuate significantly in a short space of time (e.g. the LVR in margin lending facilities).

67 The ABA's response to the ASBFEO's Small Business Loans Inquiry was that financial indicator covenants would be retained as triggers for calling a default for the following types of loans:

(a) property investment and property development loans; and

(b) specialised lending transactions including margin lending, loans to self-managed superannuation funds (SMSFs), bailment, invoice discounting, foreign currency loans, and tailored cash flow lending.

68 We recognise that the banks have limited the types of small business loans that use these financial indicator covenants as triggers for calling a default. The banks' position is that the covenants are set at a reasonable level to monitor the credit risk of the particular loan and that they are reasonably necessary to protect the legitimate interests of the banks for these particular loans.

69 We engaged with the banks to obtain specific commitments about which types of small business loans would continue to use financial indicator covenants and which covenants would be used for those loans. As a result:

(a) the banks have removed financial indicator covenants for property investment loans;

(b) two banks will apply a materiality threshold to the use of these covenants so that a breach of a covenant must present a material credit risk to the bank before it can treat the breach as an event of default;

(c) one bank has limited the use of financial indicator covenants to four types of products (i.e. property development, SMSF loans, margin lending and foreign currency loans); and

(d) one bank will treat a breach of covenant in cash flow lending as a review event (and not a default event), entitling the bank to take other action but not an enforcement action.

Note: See Table 3 in the appendix to this report for a summary of financial indicator covenants that are typically used by the banks.

70 As noted in paragraph 67, the ABA response to the ASBFEO report reserved the right to use financial indicator covenants as events of default in ‘specialised lending transactions’, which was defined inclusively as margin lending, loans to SMSFs, bailment, invoice discounting, development finance, foreign currency loans, and tailored cash flow lending.

71 ASIC expects that banks will not expand their use of this category of ‘specialised lending transactions’ to cover a wide range of small business lending products. We consider that this category covers only those lending contracts where it is reasonable to include carefully targeted financial indicator covenants as events of default so that the bank can manage the risk of a payment default, due to the following characteristics of the facility:

(a) the unpredictable nature of the borrower’s likely cash flow to repay the facility;

(b) the expected volatility in the value of the security property; or

(c) the limited recourse nature of the facility.

72 A question remains whether a term of the loan contract that makes every breach of a financial indicator covenant a trigger for calling a default and enforcing the loan is unfair. One issue is disproportionate response to a breach of a covenant. For example, an interest cover ratio covenant may require income to be six times interest. A fall in income to 5.5 times interest would be a breach of the covenant but not necessarily one that presents a material credit risk for the lender which requires enforcing the loan. If the term entitles the lender to enforce the loan for any breach of any financial indicator covenant, regardless of whether the breach creates a material risk of non-payment or of inability to enforce any security, the term may be unfair.

73 We will monitor the use of these covenants by the banks to ensure they are not being applied inappropriately or unfairly to small business loans. In particular, we will examine the banks' use of covenants to ensure disproportionate enforcement actions are not being taken in response to a breach of a covenant.

Risk for lenders: Financial indicator covenants

The risk of non-compliance with the unfair contract terms law is likely to be high if the contract entitles lenders to treat every breach of a financial indicator covenant as an event of default entitling enforcement action, even where the breach does not present a material credit risk to the lender (i.e. the risk of a monetary default or of the lender being unable to recover the amount of the loan from the secured property).

Unilateral variation clauses

74 Unilateral varation clauses in small business loans are terms that give lenders (but not borrowers) a very broad discretion to unilaterally vary terms and conditions of the contract, without the consent of the small business borrower. The unfair contract terms law identifies this type of clause in a list of terms that may be unfair.

75 In *ACCC v JJ Richards*, the court declared unfair and void a term which allowed JJ Richards to unilaterally increase its prices for any reason. The court found that such a term created a significant imbalance because no such corresponding right was given to the small business customer to terminate the contract or obtain a change in the scope or scale of the service provided by JJ Richards, or a lower price: see *ACCC v JJ Richards* (at [56]).

76 Broad unilateral variation clauses were also found to be unfair by the Federal Court in a consent judgment in *ACCC v ByteCard* in July 2013 (see paragraph 37) and by the Victorian Civil and Adminstrative Tribunal in *Director of Consumer Affairs Victoria v AAPT Limited* [2006] VCAT 1493 at [54] and *Director of Consumer Affairs Victoria v Trainstation Health Clubs Pty Ltd* [2008] VCAT 2092 under the similar Victorian unfair contract terms law which predated the Australian Consumer Law: see Pt 2B of the *Fair Trading Act 1999* (Vic).

77 These clauses cause a significant imbalance in the rights of the lender and small business borrower (in favour of the lender) and are unlikely to be reasonably necessary to protect the legitimate interests of the lender where the breadth of the circumstances in which they can be used and the types of variations they can be used to create.

78 For example, in addition to a list of specified changes that a bank could make, one bank's small business loan contract previously contained a unilateral variation clause that allowed the bank to make changes to any of the terms and conditions of the contract other than the changes as specified in the list.

79 We consider that lenders can reduce the risk of non-compliance with the unfair contract terms law if a variation clause only allows specified types of terms, or terms with a specified subject matter (rather than 'any' term or 'any other' term), to be varied in specified ways and the specific circumstances in which the clause may be used are clearly expressed.

80 Case law on unfair contract terms in consumer contracts also suggests that the imbalance created by a unilateral variation clause can also be counterbalanced if the borrower has sufficient advance notice of the variation before it comes into effect to give the borrower a real and reasonable opportunity to exit the contract without penalty rather than accept the variation. This reduces the likelihood of significant imbalance in rights and obligations and of detriment.

81 A borrower cannot exit a loan contract without repaying the loan. A real and reasonable opportunity to exit a loan contract (i.e. repay by selling assets or a business or arrange re-finance of the loan contract) is likely to mean at least 30 calendar days (but for larger drawn facilities this may be 90 to 120 days).

82 The borrower should also not incur fees, costs or detriment under the contract for exercising the option to exit the contract because of the change.

83 The banks have taken different approaches to dealing with this issue:

(a) Three banks removed clauses that allow variations to any clause or 'any other clause' in any circumstances, and retained the ability to vary in specific circumstances (e.g. changes to a rate of interest when a benchmark rate changes or changes to a margin on a base interest rate when certain promotional conditions are no longer met).

(b) One bank retained its clause that allows variations to 'any other clause' but qualified the clause so that the change can only be made if it is 'not adverse' to the borrower. The bank will provide 30 calendar days' notice if the change is not adverse to any borrower affected by the change.

84 In relation to advance notice periods:

(a) One bank will now provide 90 calendar days' notice if a variation only applies to the particular small business borrower's contract and if the change is materially adverse to the borrower.

(b) One bank will now provide 90 calendar days' notice for all changes unless the change is not adverse to any borrower affected by the change.

(c) Two banks will now provide 30 calendar days' notice or such longer period as may be required under the Code of Banking Practice.

85 As the unfair contract terms law is not prescriptive, in general the longer the notice period, the smaller the risk that the unilateral variation clause will be found to be unfair by a court.

86 We will monitor the use of these clauses by the banks to ensure they are not being applied unfairly to small business loans.

Risk for lenders: Unilateral variation clauses

The risk of non-compliance with the unfair contract terms law is likely to be high if:

- a unilateral variation clause allows the lender a broad discretion to unilaterally vary any terms or conditions of the contract in unspecified ways, and the relevant circumstances in which the variation power can be used are not specifically and clearly expressed; and
- sufficient advance notice of the variation is not given to allow a small business borrower to have a real and reasonable opportunity to exit the contract (e.g. by refinancing or selling assets if needed to repay the facility) without penalty rather than accept the variation.

C Next steps

Key points

The banks will use multiple communication channels to advise their small business borrowers about the changes, including directly contacting all relevant small business borrowers who entered into or renewed a loan from 12 November 2016.

ASIC will monitor the individual banks' use of the changed clauses to determine if they are in fact applied or relied on in an unfair manner.

We will also conduct a review of small business loan contracts from other lenders, including bank and non-bank lenders to ensure that their small business contracts do not contain unfair terms.

Communication with small business

87 The banks will use multiple communication channels (e.g. internet banking notifications, emails, mail, press release, website banners) to advise small business borrowers about the changes that apply to all relevant small business loan contracts entered into or renewed from 12 November 2016 (i.e. when the unfair contract terms law applied to small business loans).

ASIC monitoring and follow-up work

88 To ensure that the changes do not operate unfairly in practice, ASIC will monitor the banks' use of the changed clauses to ensure they have been applied and are not relied on in an unfair manner.

89 We may also undertake further work to examine small business loan contracts from other lenders to ensure that these contracts do not contain unfair terms.

90 ASIC will continue to work with the ASBFEO when assessing the results of the monitoring work.

Appendix: Summary of the banks' approaches to small business loan contracts

Table 2: Specific events of non-monetary default

Specific events	Summary of the banks' approaches
Unlawful behaviour	• Three banks will allow a breach to be remediable and provide a period ranging from 10 business days to 30 calendar days for remediation. • Three banks will adopt a materiality threshold.
Other creditor enforcement	• All four banks will not allow a breach to be remediable. • All four banks will adopt a materiality threshold.
Misrepresentation	• Two banks will allow a breach to be remediable and provide a period of 30 calendar days for remediation. • All four banks will adopt a materiality threshold.
Use of the loan for non-approved purpose	• All four banks will allow a breach to be remediable and provide a period ranging from 10 business days to 30 calendar days for remediation. • Three banks will adopt a materiality threshold.
Improper dealing with loan security or without consent	• Two banks will allow a breach to be remediable and provide a period ranging from 5 business days and 30 calendar days for remediation. • All four banks will adopt a materiality threshold.
Change of beneficial control of company except as permitted	• All four banks will allow a breach to be remediable and provide a period ranging from 10 business days to 30 calendar days for remediation. Note: One bank will only allow a breach to be remediable for a change of ownership or control of company except as permitted. • All four banks will adopt a materiality threshold. Note: One bank will adopt the threshold for a change in management only, and one bank will adopt the threshold for a change of ownership or control of company except as permitted.
Loss of licence or permit to conduct business	• All four banks will allow a breach to be remediable and provide a period ranging from 10 business days to 30 calendar days for remediation. • Three banks will adopt a materiality threshold.
Failure to provide proper accounts	• All four banks will allow a breach to be remediable and provide a period of 30 calendar days for remediation. • One bank will adopt a materiality threshold.
Failure to maintain insurance	• All four banks will allow a breach to be remediable and provide a period ranging from 10 business days to 30 calendar days for remediation. • One bank will adopt a materiality threshold.

Table 3: Financial indicator covenants

Loan type	Covenants typically used by the banks
Property development	• LVR • Cost-to-complete
SMSF lending	• LVR
Margin lending	• LVR
Foreign currency loans	• Currency equalisation clause

Key terms

Term	Meaning in this document
ABA	Australian Bankers' Association
ACCC	Australian Competition and Consumer Commission
ACCC v ByteCard	*Australian Competition and Consumer Commission v ByteCard Pty Limited* 301 FCA 2013
ACCC v JJ Richards	*Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
Australian Consumer Law	Uniform legislation for consumer protection in Sch 2 to the *Competition and Consumer Act 2010*, which applies as a law of the Commonwealth of Australia and is incorporated into the law of each of Australia's states and territories
banks	The Australia and New Zealand Banking Group Limited. the Commonwealth Bank of Australia (including Bankwest), the National Australia Bank of Australia, and Westpac Banking Corporation and St George Bank (including Bank of Melbourne and BankSA)
big four banks	See 'banks'
financial indicator covenant	A condition (typically in the form of a ratio) that the small business borrower must meet (e.g. staying above or below a level specified in the contract)
materiality threshold	A measure of whether a breach of a specific event creates a material risk to the lender of a monetary default or of the lender being unable to enforce its rights against any secured property Note: This could involve incorporating a credit risk-related materiality element into the definitions of the specific events, or applying a separate material credit risk test.
s12GND (for example)	A section of the ASIC Act (in this example, numbered 12GND), unless otherwise specified
small business loan contract	A standard form contract for a small business loan
SMSF	Self-managed superannuation fund
unfair contract terms	The unfair contract terms provisions applying to consumers under the Australian Consumer Law, which were extended to cover standard form small business contracts under $1 million with effect from 12 November 2016

Related information

Headnotes

Australian Consumer Law, broad indemnification clauses, entire agreement clauses, events of default clauses, financial indicator covenants, material credit risk, small business, small business borrowers, small business contracts, small business loans, unfair contract terms, unilateral variation clauses

Legislation

ASIC Act, Div 2 of Pt 2, subdiv BA

Competition and Consumer Act 2010, Sch 2

Fair Trading Act 1999 (Vic), Pt 2B

Cases

Australian Competition and Consumer Commission v Chrisco Hampers Australia Ltd (2015) 239 FCR 33

Australian Competition and Consumer Commission v ByteCard Pty Limited [2013] 301 FCA

Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd [2017] FCA 1224

Director of Consumer Affairs Victoria v AAPT Limited [2006] VCAT 1493

Director of Consumer Affairs Victoria v Trainstation Health Clubs Pty Ltd [2008] VCAT 2092

Information sheets

INFO 211 *Unfair contract term protections for small businesses*

Media and other releases

17-056MR *ASIC and ASBFEO join forces to ensure bank lenders meet unfair contract laws* (9 March 2017)

17-139MR *ASIC and ASBFEO hold banks to account on unfair contract terms* (16 May 2017)

17-278MR *Big four banks change loan contracts to eliminate unfair terms* (24 August 2017)

Other references

ACCC, *Unfair terms in small business contracts: A review of selected industries* (November 2016)

ASBFEO, *Inquiry into small business loans* (February 2017)

