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

Round 3 Hearing

Legal Aid NSW

Introductory remarks

Legal Aid NSW welcomes the opportunity to provide written submissions following Round Three of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the **Commission**).

Our submission focuses on the case study of Ms Carolyn Flanagan, a client assisted by Legal Aid NSW. Our response to the general questions raised by the Commission is directly informed by the legal services we provide to consumers and guarantors of business loans for the benefit of a third party[1]. We also suggest possible areas for reform and further areas of inquiry.

The Commission has highlighted critical systemic issues in the conduct of banks taking a guarantee from a third party for a business loan. Legal Aid NSW's experience is that this conduct is apparent across the financial services sector, with the impact of this conduct leading to particularly egregious and harsh outcomes for vulnerable, older people who face the risk of losing their homes.

Case study: Carolyn Flanagan

Q1. Is there any inadequacy or gap in those established protections? If so, what is it? If not, would the protections apply in the case of Ms Flanagan?

Yes, Legal Aid NSW's experience assisting Ms Flanagan, and other clients in similar situations, demonstrates that the current legal protections are inadequate.

Established legal protections

The Commission noted an established set of legal protections capable of being relied upon by a person in the position of Ms Flanagan. These protections include:

- Equitable principles in relation to unconscionability, as outlined in cases such as *Amadio* and *Garcia*;
- A national statutory prohibition on unconscionable conduct in relation to financial services; and

[1] In the 2016 / 2017 financial year Legal Aid NSW provided 2,230 legal services in credit matters, including 263 legal services for clients at risk of mortgage repossession

- Statutory remedies available for contracts made in NSW under the *Contracts Review Act 2001* (NSW).

Gaps in legal protections

Legal Aid NSW considers that the following gaps exist in the current legal protections.

1. Protections operate after the transaction

As the Commission noted, these legal protections operate after the transaction has been completed and do little to prevent a person from entering into a guarantee likely to cause them substantial hardship, apart from providing a potential deterrence function to a well-informed banker.

2. Protections are legally complex to argue

The legal protections available are reliant on the guarantor identifying an unconscionable conduct or unjust contract claim, or having the resources to engage a representative to plead these claims. These claims can be made and resolved efficiently via Internal Dispute Resolution or External Dispute Resolution mechanisms. However, where multiple parties, such as a broker or the beneficiary of the loan are involved, or where the case raises complex issues, as is often the case, a court may be a more appropriate forum. Litigating these disputes can be expensive, legally complex, stressful and time-consuming for guarantors. These factors, in addition to the financial power and resources of the bank, mean that the guarantor may be hesitant to litigate their claim.

3. Protections have had an inconsistent application by courts

Unconscionable conduct and unjust contract claims are difficult concepts to articulate. The application of these legal principles has been inconsistent in decided cases, which has further contributed to this difficulty. The lack of predictability as to how a court may decide an unconscionable conduct or unjust contract claim acts as a deterrent to potential claimants in litigating their dispute, particularly in the context of the risk of incurring a costs order.

4. Presence of legal advice can restrict availability of protections

Whether or not a guarantor received legal advice is a relevant factor when considering if the contract is unfair under the *Contracts Review Act*. Recommending independent legal advice is a factor that may relieve a lender of responsibility for unfair conduct, under the decision of *Garcia.* It is unclear from the evidence that Ms Flanagan received legal advice. Even if she did, there are serious concerns about the limited scope of the advice as well as its independence from the borrower. We consider it inadequate that the mere presence of legal advice may restrict the utility of the current legal protections of unconscionable conduct and unjust contract claims. It is paramount that any advice received by potential

guarantors is truly independent, informed advice which explains the transaction, evaluates its risks and advises whether to enter into the transaction.

Improvements to legal protections

Our clients, like Ms Flanagan, who have agreed to be guarantors for credit contracts taken out for the benefit of third parties, are frequently vulnerable, elderly people. Often, these clients view the transaction as providing personal help to a loved one, without fully understanding the legal implications, or likely outcome, of the contract. Some clients may have been pressured or misled by family members to sign guarantees, only to later realise the legal implications of the agreement after the borrower has defaulted on the credit contract.

In these circumstances, it is paramount that improvements are made to legal protections available for prospective guarantors, particularly at the point of considering and entering into the guarantee. The recommendations proposed by the Code of Banking Practice Independent Review's (the **Khoury Review**) are a positive start in this process, however we consider that the recommendations do not go far enough in protecting vulnerable people from entering into guarantees which could cause substantial hardship. Further, the Code of Banking Practice (the **Code**) has limitations in its reach. It is only binding on banks who volunteer to be bound by it, and it does not apply to non-bank lenders.

As has been raised by consumer advocate groups[2] during the Khoury Review, improvements should be made to the Code in the areas noted below. Given the limitations in reach of the Code, we also suggest reform in respect of the *National Consumer Credit Protection Act 2009* (Cth) (the **NCCPA**) in its application to guarantors of business loans.

1. <u>Suitability assessment in respect of guarantors</u>

Allowing a Centrelink recipient (usually an older person or a person with a disability) to act as a guarantor means that an already vulnerable person will likely become homeless, or dependent on social housing funded by the State, if the debtor defaults on the credit contract.

We consider that the Code should impose a positive obligation on banks to assess the suitability of the loan for the guarantor, in particular if the arrangement would cause the guarantor substantial hardship if the guarantee is called upon. We also consider that the suitability assessment in the responsible lending provisions of the NCCPA should apply in this context.

These changes would be facilitated by existing guidance about the meaning of substantial hardship. For example, ASIC Regulatory Guide 209 notes that factors such as the source of a

[2] Legal Aid NSW submission to the Australian Bankers' Association, August 2016, accessed at: http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/01/05-Legal-Aid-NSW-Submission-Review-of-Code-of-Banking-Practice-CCMC.pdf
Joint Consumer Advocate submission to the Australian Bankers' Association, August 2016, accessed at: http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/01/24-Joint-Consumer-Submission-Review-of-Code-of-Banking-Practice-CCMC.pdf

consumer's income (including whether all or part of the consumer's gross income is sourced from payments under the *Social Security Act 1991*) and whether the consumer is likely to have to sell their assets to meet their payment obligations, could be taken into account when considering if a transaction is likely to result in substantial hardship. If the transaction is likely to result in substantial hardship then the prospective agreement should be deemed unsuitable for the guarantor.

Legal and financial advice should not be able to "cure" a guarantee that is assessed as unsuitable.

2. Advice to guarantors about impact on Centrelink income

Centrelink and the Department of Veteran Affairs have strict gifting rules, which may affect a person's Centrelink income when that person gives away assets or transfers them for less that their market value. Vulnerable, older people are often caught up in these rules where they guarantee their home for the benefit of a third party. Where the debtor defaults on the credit contract, as in the case of Ms Flanagan, he or she risks losing their home and their pension, or having their income reduced because of the gifting rules.

Ms Flanagan's case demonstrates the need for additional safeguards in the Code about the impact of the gifting rules to ensure that vulnerable people are not placed in further hardship. For example, we suggested in our submission[3] to the Khoury Review that the Code could be amended to:

- Require banks to provide a mandatory disclosure notice to customers informing them that acting as a guarantor (and also mortgaging a property) can affect the guarantor's Centrelink income;
- Require banks to have a discussion with the guarantor about the content of this disclosure notice; and
- Require guarantors to provide evidence to the bank that they have received legal and financial advice about the potential impact of the guarantee on their Centrelink income.

3. Advice to guarantors about impact on aged care and other health needs

Entering into a guarantee may impact the fees and charges associated with residential aged care, as well as a person's ability to access their choice of residential aged or health care facilities.

We recommend that the Code should:

- Require banks to provide a mandatory disclosure notice to customers informing them that acting as a guarantor (and also mortgaging a property) can affect the guarantor's aged and health care choices;

[3] Legal Aid NSW submission to the Australian Bankers' Association, August 2016, accessed at: http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/01/05-Legal-Aid-NSW-Submission-Review-of-Code-of-Banking-Practice-CCMC.pdf

- Require banks to have a discussion with the guarantor about the content of this disclosure notice; and
- Require guarantors to provide evidence to the bank that they have received legal and financial advice about the potential impact of the guarantee on their aged and health care.

4. Promoting informed decision-making

Legal advice is crucial in allowing customers to make fully informed decisions about guarantee agreements, and helps prevent both parties entering into unsuitable or unfair contracts. As noted above, any advice received by potential guarantors must be independent, informed advice which explains the transaction, evaluates its risks and advises whether to enter into the transaction.

We recommend that the present requirement in the Code that a bank notify the guarantor that they should seek independent legal advice should be strengthened. The present requirement should be accompanied by a positive obligation on the bank to obtain written notice from the guarantor as to:

- Whether they have obtained independent legal and financial advice; and
- Where they have not obtained this advice, indicating that they understand that they have actively waived their right to do so.

Banks should also have a positive obligation under the Code to provide further information to the guarantor, such as the borrower's financial position, that the guarantor's income is being relied upon, the reasons why the bank requires a guarantee before entering into the credit contract, and any assessment that the loan is not unsuitable to the guarantor. We consider that this information will assist the guarantor's lawyer to provide meaningful and tailored advice about the guarantee.

5. Period for consideration of debtor's credit history

The Code obliges banks to provide potential guarantors with information about the debtor's credit history. However, the proposed Code only allows a guarantor a period of three days to consider this information, and this period of time does not apply where the potential guarantor has received legal advice.

In our experience, clients are often considering becoming a guarantor for a family member and often make these decisions based on emotional, rather than financial, considerations. With this in mind, we consider that three days is inadequate for a guarantor to properly consider their options, especially as these reflections help the guarantor to make a significant financial decision which may affect their home.

We recommend that a guarantor be allowed to consider any information provided under the Code for a seven day period, rather than a three day period. Given the limitations of receiving legal advice that were raised in Ms Flanagan's case, we also recommend that

prospective guarantors who have received legal advice should also be entitled to a seven day period to consider the relevant information.

Q2. Is it desirable to take steps to increase the likelihood that a third party guarantor of business borrowings will be properly advised and make an informed decision before entering a guarantee? And, if so, what might those steps be?

Legal Aid NSW considers that ensuring proper advice is provided before an individual makes a decision to enter a guarantee is an essential component of protections provided to potential guarantors. As discussed in the previous question, advice should include potential consequences for social security benefits, and the impact a guarantee may have for an individual seeking to enter aged residential care.

Legal Aid NSW supports the suggestion that banks should be required to:

- Record in writing their assessment of the serviceability of the loan; and
- Provide this information to the guarantor's solicitor who must consider the information in the course of providing legal advice about the guarantee to the guarantor.

As referred to above, the information provided to the solicitor should also include:

- The bank's assessment of the suitability of the guarantee, in particular if the guarantee could cause substantial hardship if called upon;
- The borrower's financial position;
- Whether the guarantor's income is being relied upon; and
- The reason why the bank requires a guarantee before entering the credit contract.

The information provided to the solicitor and guarantor could also include a warning about the number of businesses that fail in the bank's experience, where possible. For example, the bank could inform the guarantor that franchises similar to the franchise being purchased by the business loan commonly fail within a certain period of time, such that the guarantee is called upon.

While this may increase the burden on the solicitor advising the guarantor, it may also result in meaningful advice being provided and increase the likelihood that a guarantor makes an informed decision. The provision of additional financial information concerning serviceability would help ensure that the banker's mind is turned to their duty to the guarantor to act as a diligent and prudent banker in the provision of the loan.

Further, the creation of such a document would assist by way of creating a record of both why certain decisions have been made, and what advice was given to the guarantor. In the case study of Ms Flanagan, there was a notable absence of file notes setting out what, if any, assessment had been made of the serviceability of the loan. Ms Flanagan instructed Legal Aid NSW that the banker had given her a verbal assurance that the borrower could "cover" the loan repayments. The banker had since left Westpac and was not interviewed by Westpac. Given the length of time a loan can run, it will often be the case that bank staff

are no longer employed by the bank by the time a dispute arises. As the Commissioner noted, an executor of a will may have an interest in knowing what advice was given, and when that advice was given, after the guarantor has passed away. A written statement of serviceability would assist all parties in the future who may have an interest in knowing about advice given to the guarantor.

Plain language

Particular consideration needs to be given to the way information is provided to vulnerable groups, such as older customers, those with a disability and those in remote indigenous communities. Information should be provided in a manner that is accessible and meaningful to the individual that it is provided to.