Australian Banking Association

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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
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Inquiry into Corporate Insolvency in Australia

The Australian Banking Association (**ABA**) welcomes the opportunity to comment on the Parliamentary Joint Committee on Corporations and Financial Service's inquiry into the effectiveness of Australia's corporate insolvency laws in protecting and maximising value for the benefit of all interested parties and the economy.

While the ABA sets out it's specific responses to the Terms of Reference below, we encourage the Government to consider any changes in the context of the broad suite of reforms made or proposed in recent years that potentially change the consequences of insolvency for companies and bankruptcy for individuals. This includes small business insolvency reforms, changes to schemes of arrangement and the review of the safe harbour regime.

The ABA also highlights the need for Government and policymakers to adequately consider how these reforms may impact credit decisioning and product costs, and whether the right balance is achieved between creditors and debtors from these reforms.

Overarching principles

In this regard the ABA has developed a set of principles that provide a framework for considering Government and regulator consultations on proposed reform, as well as advocacy and stakeholder engagement by the industry as follows.

1. Support for customers / debtors

Support and care for our customers is a cornerstone of banks' relationship with their customers and community. When considering changes / reforms to corporate insolvency laws, an appropriate balance should be sought between the longer-term viability of customers, their business and assets, community expectation and, expectations of risk appetite.

2. Effective and cohesive reform

Continuous improvement of formal and informal insolvency processes is necessary for a thriving economy and efficient capital allocation.

However, proposed change must address an identified issue of concern or area of policy and ultimately contribute to clearly defined strategic and policy goals over the longer term. It should also be considered together with other related proposed reforms so that multiple reforms touching on insolvency are considered together.

Cohesion with other areas of policy and regulation is necessary to ensure economic efficiency and consistent and certain outcomes for stakeholders.

3. Appropriate protections for all stakeholders

Banks engage with customers who are managing financial distress as well as with customers who are creditors of entities going through financial distress. As an industry, banks are uniquely placed to see the direct, consequential, and flow-on impact of financial distress.

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Appropriate protections for, and recognition of, different stakeholder needs and outcomes should be embedded in restructuring and insolvency processes. Such processes should aim to provide protections to stakeholders, including employees, trade creditors (many of whom are small businesses), unsecured lenders, secured creditors and equity-holders that are balanced and recognise stakeholder risk profiles.

Shifting the balance of protections in favour of debtors means less protection for other stakeholders, increases the level of risk attributed to customers (borrowers) and can impact risk appetite and credit decisions.

4. Access to capital and sustainable lending

Banks are committed to supporting customers and providing capital to assist and support viable customer growth. Banks have many regulatory frameworks for compliance and to provide protections to customers and to manage capital exposures. Capital is made available to customers taking all relevant circumstances into account, including risk appetite of the bank.

Insolvency reform should not lead to unintended or adverse consequences for customers or the economy in the short or long term. Changes to creditor rights may change the actual and / or perceived risk and the ability of banks to support customers.

5. Flexible insolvency options and early debtor engagement

Stakeholders benefit from having a range of restructuring options available to them. Informal and formal options can be used to achieve strategic aims. A range of options to allow flexibility and suitability of the restructuring process depending on the size and complexity of the structures will achieve better outcomes for stakeholders.

Early engagement with restructuring professionals, creditors and restructuring processes gives debtors the widest universe of restructuring options available. Reforms focused on improving early engagement by reducing perceived stigma and improving information and education in relation to the different processes support better outcomes for customers.

6. Incentives for positive behaviour and good conduct by stakeholders

Reform measures that encourage all stakeholders to engage constructively and proactively in a formal or informal restructuring process should be supported as they lead to better outcomes for stakeholders.

7. Appropriate and independent oversight, guidance, and advice to stakeholders

Reform measures should be supported by appropriate oversight and guidance from Treasury and regulators to ensure the purpose and intended outcomes of the reforms are achieved. Reform should support and embed review timetables to allow for monitoring and any further reform to achieve stated policy objectives.

Fundamental to these principles is considering whether the insolvency process appropriately and adequately balances debtor and creditor rights and protections when a debtor finds itself in financial distress. Reform should be consistent and aimed at:

(a) achieving clearly articulated policy outcomes;

(b) seeking to strike an appropriate balance between the rights and protection of these stakeholders;

(c) considering risk appetite of respective stakeholders; and

(d) facilitating opportunities for debtors to engage with both formal and informal restructuring options.

Our response to the Terms of Reference

The ABA's position is summarised as follows:

- the review should be guided by the set of overarching principles above, aimed at adequately balancing debtor and creditor rights and protections;
- a key focus of the review should be improving access for small business;
- reforms should be cognisant of the resources and capabilities of the industry in managing a change in demand for professional services;
- reforms should improve access to insolvency processes through clear, simple and cost-effective solutions; and
- the review should have regard to overseas experiences such as Singapore and the United Kingdom.

Our response to the terms of reference is as follows:

1: Recent and emerging trends in the use of corporate insolvency and related practices in Australia, including in regard to:

a. temporary COVID-19 pandemic insolvency measures, and other policy measures introduced in response to the pandemic that may have had an effect on such trends and practices;

b. recent changes in domestic and international economic conditions, increases in material and input costs for businesses and inflationary pressures more broadly, and supply shortages in certain industries; and

c. any other contributory factors or events that have impacted insolvency patterns

Current insolvency trends

The ABA notes that post-COVID-19 insolvencies remain lower than the prior historical average.[1]

If insolvencies were to return to, or exceed, historical averages, the ABA questions the capacity of the industry to accommodate such an increase given current resources (such as practitioner numbers), and whether the industry has contingency plans for such an event. The ABA suggests that the review considers the impact of any reforms on both capacity and capability within the industry.

2: The operation of the existing legislation, common law, and regulatory arrangements, including:

a. the small business restructuring reforms (2021);

b. the simplified liquidation reforms (2021);

c. the unlawful phoenixing reforms (2019); and

d. the operation of the *Personal Property Securities Act 2009* in the context of corporate insolvency

Small business restructuring reforms

The ABA recommends that small business should be a key focus of the review. In relation to the small business restructuring reforms, the review should have regard to the following considerations:

[1] In the FY21-22, there were 6,483 companies that appointed an external administrator or controller, compared to an average of 10,744 for FY17, 18 & 19 (see Australian insolvency statistics, ASIC, 14 November 2022).

- There is limited use of, and access to, the small business restructuring reforms at the current threshold of $1 million of total liabilities. Accordingly, the ABA recommends that consideration is given in the review to expanding the regime to a threshold of between $2 – 5 million in debt (noting that the latter would be more consistent with the Banking Code of Practice).
- Many small businesses would benefit from a simpler, cheaper, and quicker process focusing on small business with simple debt arrangements, limited number of employees and good corporate conduct. Companies with more complex debt arrangements or not demonstrating good corporate conduct should follow the existing processes which provide protections for secured and unsecured creditors as well as investigative powers to external administrators.
- The cost of small business insolvencies should be measured against financial indicators, such as available assets. The cost of insolvency against these measures for small business are significant, given the minimum requirements to conduct an insolvency and the cost of legal action.
- As possible solutions, the Parliamentary Joint Committee should consider:
  - (a) Increasing the availability of the of the "simplified liquidation" regime under section 500A of the *Corporations Act 2001* (Cth) (**Corporations Act**) that has reduced requirements for liquidators and creditors; and
  - (b) an insolvency court or panel for simple insolvency matters such as preferences, insolvent trading issues, debt collection and trust litigation.
- A number of additional changes should also be considered to assist small business. For example, the requirements for small businesses to have their ATO lodgements and employee obligations up to date could be further clarified to address all potential obligations. In addition some flexibility could be introduced to consider events outside the control of a small business such as natural disasters. A number of small businesses are likely to be excluded from the process if strict compliance with the abovementioned obligations is required.
- Finally, the reforms should be clearer regarding the restructuring advisor's obligations and whether the advisor is personally liable for insolvent trading. There should also be some form of protection or safe harbour during the restructure to ensure efficient administration.

The operation of the PPSA in the context of corporate insolvency

The Personal Property Securities Act (**PPSA**) has created additional complexity for secured creditors to perfect their interests. Due to difficulty navigating the requirements under the PPSA, creditors' interests are often impacted by minor errors. For example:

(a) registrations in relation to trusts are often incorrectly made against the corporate trustee and not the trust's ABN. Additional uncertainty is caused where security is granted by a trustee of a trust without an ABN that later acquires an ABN[2]; and

(b) any defect in a registration may result in a registration vesting upon an insolvency appointment or a security interest being unperfected, notwithstanding the expectation of all parties that the security interest was granted. For example, registering against an ABN instead of an ACN, or missing one digit for a serial numbered good. Currently, there is limited scope to apply to court to rectify these situations.

Schemes of arrangement

The ABA believes the review should consider modifications to Part 5.1 of the Corporations Act to allow an automatic moratorium on creditor enforcement actions (similar to voluntary administrations) applied during the formation of a scheme of arrangement, rather than the existing court approach.

[2] See PPSA, ss 164 to 165.

The Parliamentary Joint Committee should also examine the high voting thresholds in place, such as the 75% shareholder approval threshold required for the scheme. Lowering these thresholds would make access to schemes of arrangement more accessible.

The review should look at overseas jurisdictions, such as the experiences of Singapore and the United Kingdom, in determining an appropriate voting threshold.

Set-off

The ability of a secured creditor to apply a right of set-off under contractual arrangements with customers and/or under section 553C of the Corporations Act is an important assumption for credit decisions by banks, yet recent challenges and opposition to these rights are causing additional costs and uncertainty. For example, uncertainty has been caused by competing rights to circulating assets for unpaid employees (often funded by the Fair Entitlements Guarantee if the company goes into liquidation).

The ABA believes that greater clarity around the rights of set-off under the Corporations Act would assist in making credit decisions, including:

(a) when set-off may be exercised; and

(b) circulating assets or the use of circulating assets to support continued trade of an operating business.

This would minimise the need for court applications and legal advice in relation to distributions, which ultimately reduces the return to creditors. However, any clarity provided at law must not disturb the contractual right to set-off where a creditor brings an action.

Pre-Insolvency access to advisors such as rural financial counsellors

The ABA believes there is a lack of consistent access and advice options relating to pre-insolvency. Where pre-insolvency customers engage with trusted advisors, such as rural financial counsellors in matters related to farm business debt, the ABA sees better outcomes for those customers. Accordingly, the ABA recommends that access to resources such as advisors be broadened.

3: Other potential areas for reform, such as:

a. unfair preference claims;
b. trusts with corporate trustees;
c. insolvent trading safe harbours; and
d. international approaches and developments

Trusts with corporate trustees

Many Australian businesses are set up with trust structures, including many small businesses where a corporate entity does not carry on any business in its own right, but instead acts as the trustee of a single trust. Where a trust deed contains an ejection clause, this requires an additional and expensive step in external administrations, as a court application is often required to appoint receivers over trust property (otherwise, an external administrator of the corporate trustee's ability to deal with trust property is limited).

Conflicting case law and views in relation to the impact of ejection clauses has contributed to industry uncertainty. Such conflict could be addressed by legislation to create a consistent position regarding the impact of ejection clauses.

The ABA also notes its comments above in in relation to PPSR registrations required to perfect a security interest granted by a corporate trustee in relation to assets of a trust.

Insolvent trading safe harbours

The ABA notes its response to Treasury's review of the insolvent trading safe harbour on 1 October 2021 where it made the following recommendations:

(a) the eligibility requirements to trigger the safe harbour protections are too onerous and should be amended;
(b) use of the safe harbour should be made more cost effective;
(c) the safe harbour regime would be improved by reducing complexity and providing more certainty in interpretation;
(d) the safe harbour regime should provide for better incentives for the involvement of professional advisers;
(e) the safe harbour regime should provide for advice to be obtained from a registered liquidator to ensure that it is appropriate;
(f) increase awareness of the safe harbour regime;
(g) any changes to the disclosure requirements for safe harbour should recognise that disclosure of the safe harbour restructuring plan is not appropriate in all circumstances; and
(h) consider shifting the burden of proof to establish safe harbour defences to insolvent trading.

While the ABA considers that the existing safe harbour regime is operating as intended and consistent with its 2021 response, consideration should be given to the cost of the regime which effectively prohibits its extended application to small-to-medium enterprises (**SMEs**).

International approaches and developments

The ABA believes that it is appropriate to review and improve Australia's existing corporate insolvency regime, rather than replacing it. In this respect the Parliamentary Joint Committee should look to the United Kingdom and Singapore's balanced regimes when undertaking its review.

For example, Virgin Australia's turnaround under Australia's insolvency regime following its voluntary administration at the beginning of the COVID-19 pandemic in comparison to the experience of other international airlines, demonstrates the benefits of improving, rather than replacing, the existing regime.

The ABA considers that all stakeholders should be cautious in considering a United States Chapter 11-style debtor in possession model overseen by a court, as it would represent a material change from Australia's existing insolvency laws and could lead to unintended consequences. Australian insolvency processes are generally creditor-led processes overseen by a registered liquidator (except for a handful of Schemes of Arrangement and Small Business Insolvencies).

Introducing a debtor in possession model where the debtor appoints a restructuring practitioner will add further complexity and cost to Australian insolvency law as it will require a new set of processes/rules for matters including court supervision, creditor classes, voting thresholds, cram down and priority financing.

The ABA considers that at this point in time, Australia's court system would not be equipped to cope with this model. The increased costs, ability to cram down and lack of control (among other changes) will impact all creditors, particularly unsecured creditors. The process will ultimately be paid for by creditors, and an impact on bank recoveries may impact credit decisions / margins and result in higher interest rates.

The introduction of an additional complex model for corporate restructuring does not appear to be warranted in the current Australian insolvency and restructuring market. Rather, the review should focus on improvements and simplifications to existing processes which work and mostly do not require wholesale changes, particularly in circumstances where the current Australian restructuring market is more mature compared to when previous reviews were undertaken.

6: The role of government agencies in the corporate insolvency system, including:

a. the role and effectiveness of ASIC as the corporate insolvency regulator;

b. the ATO's role and enforcement approaches to corporate insolvency, and relevant changes to its approach over the course of the COVID-19 pandemic;

c. the role, funding**,** and operation of relevant bodies, including the Assetless Administration Fund and the Small Business Ombudsman

The role of ASIC

There are onerous and expensive reporting obligations for administrators and liquidations, often at their own costs, to investigate the affairs of the company and report to creditors and ASIC. For example, liquidators often have limited funding, or need to use company assets that could otherwise be available for creditors, to prepare section 533 reports. This requirement could be limited to prescribed cases involving extensive breaches and/or larger creditor pools.

Further, ASIC appears to have resource challenges in discharging their powers, such as investigating identified issues and taking action in relation to corporate insolvency matters (e.g., the conduct of directors). The ABA believes that reducing the administrative burden on liquidators and increasing resources available to ASIC could result in better outcomes for investigating misconduct.

The ABA recommends that the review focuses on how ASIC could be better supported to discharge its duties and powers in relation to corporate insolvency.

7: Any related corporate insolvency matters

The ABA notes that in conducting its review, the Parliamentary Joint Committee should:

(a) speak with other industry bodies for their perspectives, such as ARITA – the Australian Restructuring Insolvency and Turnaround Association, the Turnaround Management Association, INSOL, Rural Financial Counselling Services (RFCS) and the Financial Counselling Australia Small Business Debt Helpline service; and
(b) revisit previous government reforms to ensure a holistic, rather than piecemeal, approach to reform.

The ABA looks forward to continued engagement on these matters and welcomes the opportunity to further discuss the issues raised above.

Yours sincerely,

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