Standard Form Contracts and the unlawful “Claw-Back” Clause in the Bank/Lender/ Finance broker contracting Agreement.

Treasury released a Consultation Regulation Impact Statement on Enhancements to Unfair Contract Term Protections, extending the unfair practice protections for small businesses. This submission is to bring awareness and action to remove the Unfair clawback Clause from the Standard Form Contracts in the Finance Broker Industry.

Definition of a Claw-Back as applied to the Finance Broker Industry

The focal point of this submission is the Standard Form Contract existing between a Bank/Lender and a Mortgage/Finance Broker, along with their Aggregator. It is essential to clarify that the majority of brokers (95%+) operate within the industry through a company structure, rendering them Small Businesses. Consequently, they bear the same array of compliance, tax, legal, and legislative obligations as any other Small and Medium-sized Enterprises (SMEs) in Australia. It is imperative to note that Standard Form Contract laws are equally applicable to finance and mortgage brokers (SMEs), just as they are to any other SME industry.

What constitutes a "clawback" in the finance industry? In financial terms, a clawback refers to a fee imposed by banks on all 19,200 mortgage and finance brokers (SMEs) in the event of the early repayment or refinancing of home loans and other loans (introduced and implemented to the bank by the broker) within two years of settlement. The specific fee amount varies among lenders, commonly involving the complete reimbursement of the upfront commission paid to the broker if the loan is prepaid within the initial year, and 50% of the commission within the initial two-year period.

The crux of the issue lies in the current "Clawback" clause present in all Standard Form Broker Contracts. This clause is deemed unfair as it breaches established Standard Form Contract parameters, representing a form of aggressive business conduct. The disparity in remuneration further underscores the need for a comprehensive examination of the fairness and ethical implications associated with such clauses in the finance industry.

Before 2006, the purported lender "loan mortality" losses, characterized by undisclosed figures, were encompassed within the operational expenses of the lenders. Early termination of loans was considered an inherent business risk for banks and lenders, factored into the overall fees and interest rates charged.

Around 2001, lenders introduced Deferred Establishment Fees (DEF) to borrowers closing their loan facility within the initial two years. This measure aimed to recoup early closure costs, enhancing profits and returns for shareholders. Existing interest rates and fees, inclusive of a standard loan mortality rate, remained unchanged, resulting in what can be perceived as a "double dipping" scenario within consumer contracts. DEF served to offset expenses incurred by the bank or lender during the loan establishment process, while also promoting customer retention by ensuring a minimum two-year commitment from clients.

In 2011/2012, recognizing the unfairness of lenders imposing DEF fees on consumers, the government deemed it unconscionable, leading to the enactment of legislation prohibiting this practice. However, in 2012, the landscape surrounding early exit fees underwent a shift, providing lenders with an opportunity to transfer the perceived "loss" onto brokers on a significant scale. The absence of specific legislative measures to prevent burdening small broker businesses (SME’s) facilitated the rebranding of DEF as "clawbacks," effectively transferring the associated fees and expenses to brokers.

The government has characterized the DEF fee as "unconscionable" for consumers yet permits banks to persist in imposing the repackaged fee, now termed differently, on small businesses. ASIC, the industry regulator, has not taken any action regarding this repackaging and aggressive business conduct directed at small broker businesses.

Illustrating the widespread nature of this issue and the disparity among industry participants, major banks recently reported approximately $7 billion in net profits each, with $2.85 billion derived from "clawback" income, impacting small business owners, who are identified as disadvantaged partners.

Around 2010, banks and lenders made claims that mortgage brokers engaged in client churning, whereby clients were frequently moved from one bank to another, solely to inflate the brokers' commissions per client. This narrative was employed by major financial institutions as a rationale for shifting the financial loss resulting from the Deferred Establishment Fee (DEF) from consumers to the broker industry and SME's in the form of a clawback. Algorithms existed and continue to exist that can identify brokers that might "Churn" clients and take appropriate disciplinary action against them. Implementing such measures would result in penalizing only the few brokers involved, rather than hugely impact all 19,200 brokers (SME's) in the industry today. Ironically, the DEF and the Clawback fee can be seen as essentially one and the same. Also, why did the banks NOT take action before the DEF was removed to implement clawbacks globally if they saw churning as a problem? It appears only to be a "knee-jerk" reaction to losing profit from DEF's to prop up profits lost due to legislation.

During that time, it was deemed acceptable for large businesses to exploit small businesses due to the lack of sufficient legislative safeguards in place. This assumption was based on the belief that small business owners possessed the requisite knowledge and capability to navigate such situations independently. However, the reality is that small businesses are ill-equipped to confront the power dynamics inherent in dealings with large corporations and institutions. Mortgage and Finance brokers operate every-day small businesses, they have families and commitments, and their jobs are to help consumers at ground level to get the best possible finance solution for their needs, only to have the big banks and Lenders unfairly take back the money they paid them for helping consumers.

Best Interest Duty (BID) Legislation

Around 2021, the best interest duty was implemented by the government. The best interest duty and related obligations are designed to ensure that retail clients receive advice that meets their objectives, financial situation and needs, and that you act in the best interests of your clients when providing advice. The implementation of this legislation removes any suggestion of brokers churning clients and effectively removes any argument a bank or lender might have to blame brokers for any "Loss", triggering the said clawback fee. However, the clawback fee remains. Why?

In recent times, financial institutions such as banks and lenders have been providing consumers with enticing incentives (Cash-Backs) ranging from $2,000 to $10,000 in order to encourage loan refinancing. This has prompted a significant number of individuals to refinance their loans, capitalizing on the monetary benefits offered. However, a consequential outcome of this practice, particularly advantageous for the banks and lenders, is the activation of clawbacks on brokers' commissions. Consequently, by actively promoting and initiating the refinancing process, banks and lenders are exacerbating the issue of clawbacks for brokers. Simply, Banks and Lenders are/were causing a "CHURN" type scenario themselves, the very thing they blamed brokers of doing, which actually did/does impact on broker income.

The Rule of LAW

There are two legal principles that lead us to believe that the clawback of a finance broker's (SME) commission is in violation of the law.

a) We contend that the inclusion of the clawback clause in standard form contracts may infringe upon Australian law concerning such contracts.

b) The principle of quantum meruit establishes that individuals should be remunerated for the work they perform. Consequently, it is imperative that finance brokers receive compensation for the services rendered, regardless of whether the loan facility is closed within the 12 to 24-month period stipulated or irrespective of the presence of a clawback clause within the agreement.

A Standard Form Contract

A standard form contract, under Australian Law, is a pre-drafted agreement that typically favours one party. It contains non-negotiable terms and conditions, often used in commercial transactions, where the other party has limited or no ability to negotiate or modify the contract terms. These contracts are commonly found in industries such as telecommunications, insurance, banking, and utilities. The imbalance of bargaining power between the parties can raise concerns about fairness and the protection of rights. The law recognizes the need for transparency and fairness in such contracts and provides legal safeguards to address any potential exploitation or unfairness.

A bank or lender initially establishes a standard form contract with a predetermined commission structure, which is payable to finance brokers. This contract also incorporates a clawback clause.

Essentially, the standard form contract outlines the responsibilities of the finance broker, including procuring clients for the bank, familiarizing themselves with the bank's products and guidelines, acting as the bank's representative, collecting and submitting all necessary documentation through the bank's portal for evaluation, and assisting in the loan settlement process. In return for these services, the broker is entitled to receive a commission, which covers approximately 20 hours of work and associated expenses incurred in acquiring the client.

However, the contract also includes a clawback clause, enabling the bank to recover all commission payments if the client closes the loan facility within 12 months of its inception, and 50% of the commission within 24 months. We contend that this clawback clause is in violation of "standard form contracts" under Australian law. The presence of this clause raises concerns as it essentially implies that finance brokers may end up working without compensation.

In Australia, a finance broker who has had their commission clawed back may argue that the standard form contract is "unfair" and thus voidable. As per the **Australian Consumer Law**, In deciding whether a term in a standard form consumer contract is unfair, the court or tribunal will apply the three–limbed test for unfairness. The test for unfairness, states that a term of a consumer contract is unfair if it:

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

• is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and

• would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

All three limbs of the unfairness test must be proven to exist, on the balance of probabilities, for a court to decide that a term is unfair. **The above is an excerpt from the ACCC guidance on the application of this new law, which is available at www.accc.gov.au/uct**

In this case, the finance broker may assert that the clawback clause within the standard form contract results in:

- a significant imbalance in rights and obligations, as it grants the bank the unilateral authority to reclaim commission without adequate justification. Also, the big banks individual profits of over $7billion dollars (in some cases) are earned partly at the expense of small broker business operators who contribute circa $2.85Billion pa to banks coffers and their bottom line. The banks took on the rights and obligations of approving the loan and accepting a new customer and as such, should also accept the risk of the loan being paid off in two years. Currently, brokers take ALL the risk if the loan is repaid within 2 years.
- the clause is not reasonably necessary to safeguard the bank's legitimate interests, given that the broker has already performed the services for which the commission was paid.
- The clawback clause leads to financial detriment for Brokers, as their livelihood depends on commission income, and they have already incurred expenses while providing the services that warranted the commission. Brokers incomes can be paid back to the banks in FULL, leaving a huge imbalance, especially to a small business owner who has to feed a family.

- The Broker does not have the ability to maintain the contract terms up to two years after settlement of the loan, due to outside influences (eg: banks offer "Cash-Backs up to $10,000 to entice consumers to refinance, which then triggers a clawback to the broker if the refinance is within the 2 year term of the unfair contract)

In addition to the unfair contract argument, the broker may contend that the bank acted unconscionably by exercising the clawback clause despite being aware or reasonably expected to know that it would cause financial harm to the broker. This argument can be supported by presenting evidence of the broker's financial situation and demonstrating the bank's awareness of it.

Principle of quantum meruit

Additionally, there is an entirely different rule of law called the principal of Quantum Meruit. In Australian law, the principle of quantum meruit generally applies in situations where there is no express contract or when a contract is found to be unenforceable. Quantum meruit allows for a reasonable payment to be made to a party who has provided goods or services without a pre-existing agreement regarding payment.

The principle of quantum meruit allows for a fair and reasonable payment to be made to a party who has provided valuable goods or services, ensuring that they are not unjustly deprived of compensation.

In Australian law, the principle of quantum meruit holds significant importance in contractual relationships where parties provide goods or services without a pre-existing agreement regarding payment. Quantum meruit, which translates to "as much as is deserved," allows for a reasonable payment to be made to a party who has provided valuable goods or services, based on the fair value of their contribution. There are relatable precedents of the Principal of Quantum Meruit in Australian Law.

Finance Industry Attempts to deal with Clawbacks.

The imposition of clawbacks has encountered consistent criticism from brokers since its inception, characterized as a heavy-handed and unjust approach disproportionately affecting small business owners. Notably, industry associations such as the Mortgage & Finance Association of Australia (MFAA) and the Finance Brokers Association of Australia (FBAA) acknowledge the existence of the clawback problem. However, their efforts to address the issue have been perceived as largely ineffective, despite years of advocacy on behalf of brokers. The mandatory accumulative financial contributions totalling over $8,640,000 per annum from brokers to MFAA and FBAA raise concerns about the associations' ability to negotiate and instigate positive changes for their members and also put into question their relevance given the implementation of BID (along with perceivable conflicts of interest with relationships and sponsorships from banks and Lenders).

While the Australian Financial Complaints Authority (AFCA) has distanced itself from the matter, stating that it falls outside the scope of its policy, a complaint lodged with the Australian Securities and Investments Commission (ASIC) remains unanswered to date. Notably, four class action legal firms have declined assistance in addressing the issue.

The overall landscape of this problem draws parallels to operating within a cartel, specifically the banking sector. The Small Business Commissioners office has suggested that the described clawback issue might be categorized as aggressive business conduct. As potential avenues for resolution, consideration is given to existing laws and the examination of unfair practices within Standard Form Contracts. These avenues may offer a potential recourse for the 19,200 small and medium-sized enterprises (SMEs) grappling with the implications of clawback practices.

REMEDY:

It is strongly advocated and deemed imperative that the "Clawback" clause be expeditiously removed from the Standard Form Contracts between Banks/Lenders and Mortgage and Finance Brokers, as elucidated in this document and in accordance with prevailing Australian laws.

The enactment of the Best Interest Duty (BID) on January 1, 2021, explicitly prohibited finance and mortgage brokers from engaging in client churning or any actions contrary to the best interests of the client. Given this legislative backdrop, it was expected that Banks and Lenders would proactively eliminate the clawback clause from their standard form contracts. Regrettably, this did not materialize, as these significant enterprises prioritized profits over the well-being of their small business partners. Consequently, we propose the reimbursement of all clawbacks initiated from January 1, 2021, to the finance and broker partners, considering the substantial billion-dollar profits accrued by these banks, in part at the expense of their broker partners.

The absence of a comparable unfair contract clause in any other industry prompts us to question why the finance broker industry, particularly SMEs, is subjected to such "Aggressive Business Conduct" that has gone seemingly "Unchecked. "The Business Advice agency unequivocally stands behind finance brokers and small to medium-sized enterprises (SMEs). We are currently addressing an unprecedented and unjust clause within this sector, affecting over 19,000 SMEs. Our commitment is to eliminate this inequitable provision and seek compensation for the substantial financial losses amounting to billions of dollars.

In summary: Noteworthy elements of this submission-

- ***Clawback clause in a standard Form Contract cause a significant imbalance in the parties' rights and obligations arising under the contract.***
- ***is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term.***
- ***would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.***

All three limbs above of the unfairness test must be proven to exist, on the balance of probabilities, for a court to decide that a term is unfair. ACL reference: section 24(1)   ASIC Act reference: section 12BG. Additionally:

- ***When Individual banks pocket over $7 Billion per annum net profit (collectively let's say over $50 billion pa) with small business owners (brokers) contributing circa $2.85 Billion to these profits through Clawbacks, the imbalance is that these small business owners are loosing income that feeds their families, while disproportionally, banks are profiting from the unfair contract to bolster profits.***
- ***The Broker does not have the ability to maintain the contract terms up to two years after settlement of the loan, due to outside influences (eg: banks offer "Cash-Backs up to $10,000 to entice consumers to refinance, which then triggers a clawback to the broker if the refinance is within the 2 year term of the unfair contract).***
- ***The clawback provision places an undue burden on small broker businesses, forcing them to shoulder the entire financial impact of monitory loss, should the loan facility close within two years. Despite lacking authority in, or involvement with, risk assessments related to the establishment of facilities that could lead to premature closure, brokers bear the full weight of this risk—responsibilities that should rightfully belong to the bank or lender. While the bank or lender assumes ongoing client-servicing risks and reaps the benefits of the decision, the broker's role is primarily to bring clients to the bank, aiding in information collation for application assessment. Once the loan is approved, the bank or lender should take on all associated risks as assessed at the time of approval.***

Philip Rice

Founder - Business Advice Agency