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Personal Property Securities (PPS) Law Reform

Introductory remarks

Until recently the ABA had not supported U.S. Article 9 based PPS reform.

Why?

First, during the 1990s there was a sense of regulation reform fatigue.

Secondly, despite the fragmented system of state and territory based personal property security registers and statutes banks found the system workable.

Thirdly, there was the strong concern of banks that as the traditional working capital providers to business they would be disadvantaged competitively and through credit risk by the proposed purchase money security interest priority.

The current array of PPS laws are largely state and territory statute based. These laws are numerous and lacking consistency. There are numerous registries for secured creditors to notify their PPS interests and obtain priority as regards other creditors and in the event of insolvency of the debtor.

The ABA believes that a single registry alone would provide a significantly more efficient and effective system for registration of PPS interests and for creditors to ascertain the interests that attach to items of personal property.

Reforming the substantive law on PPS has the potential to add considerably to this but that will come at a cost to the financial services industry and the challenge of changes to established procedures and documentation and possibly risk.

The ABA's Position is an "In Principle" Support for PPS Reform

The ABA gives its "in principle" support for PPS reform. Proposed reform should create efficiencies in the taking, registration, management and enforcement of personal property securities, reduce costs and legal disputation and harmonise PPS rules within Australia and with some overseas countries, particularly New Zealand.

There are some important general and specific key aspects that banks consider must be taken into account in their supporting PPS reform.

Ten Important General Considerations

- (1) The provision of financial accommodation by banks and other lenders is not just based in the law. There are other aspects including an understanding of the nature and functioning of credit markets, competition, prudential considerations, credit risk assessment and business lending considerations. Therefore the ABA believes that these factors will require a whole of government and all of Australian governments' approach to PPS reform.
- (2) As the majority of PPS laws and registries are found in the States and Territories, these jurisdictions must first agree to co-operate in a national system of PPS.
- (3) Based on New Zealand and Canadian experience, a single national scheme is the preferred model to avoid the potential for individual jurisdiction divergence from a nationally uniform model. A Commonwealth statute is desirable.
- (4) The ABA believes there should be a scoping exercise (perhaps undertaken by the Productivity Commission) so that the true costs and benefits for Australia and the legal and regulatory, competition and business financing impacts are assessed.
- (5) Overseas experience indicates that the implementation of PPS law reform was a substantial exercise. An assessment of other Australian legislative reform initiatives in train at the relevant time should be undertaken to ensure that resources and timing implications are fully understood and allowances made.
- (6) PPS reform will require a whole of institution approach by banks. This will necessitate extensive consultation with banks at critical stages in the development of the PPS model and the legislation. A commitment from all governments is needed to a national consultative structure and stakeholder engagement and management arrangements in going forward with PPS law reform.
- (7) A transitional period of at least 2 years should be available to allow banks to devise lending policies, credit risk assessment models, computer systems, settle procedural manuals and processes, re-design forms and train staff.
- (8) To achieve the desired efficiencies and minimise costs a national PPS scheme should
 - facilitate the use of simpler and standard documentation;
 - provide for a national electronic registration system which is simple and cost effective that allows streamlined and automated processes of searching, registration and discharge

- of all encumbrances, obviates cross-jurisdictional registrations and removes inconsistencies in registry requirements;
- realise a standard pricing structure that is lower than existing pricing;
 - not operate retrospectively to disturb existing security holders' rights and priorities;
 - recognise and preserve the effectiveness of the floating charge;
 - ensure the rules for priority and enforcement of securities are clear;
 - not create more onerous obligations on banks.
- (9) It would be desirable for the PPS law operating in New Zealand to be followed as closely as possible in Australia as a number of Australian banks have New Zealand subsidiaries. The same laws would add to efficiencies for banks and other financiers operating in both countries. Also, PPS law reform should be an opportunity to work with the New Zealand government to further harmonise the business laws of Australia and New Zealand.
- (10) A representative working party comprising finance industry, the practising legal and insolvency profession and governments should be established to ensure the approach to PPS reform is practical, objective and based on sound economic principles.

Five Important Specific Considerations

The ABA has identified five key aspects in the development of PPS reform that it will monitor closely.

Statutory Licences and other rights

There are a wide variety of leases, licences and rights created by statute that in some cases do not confer rights of personal property on the holder, permit the holder to use a right as collateral for its business financing needs or provide a public register for recording them.

There are other rights created by contract between a bank and its business customer that confer powers to control certain aspects of the business in much the same way as a holder of security over the business might exercise that control. Negative pledge agreements are an example of these contractual rights. The existence of these rights is of relevance to other would-be creditors of the business.

The ABA believes that there should be the facility to register security over these statutory rights and to register the existence of these contractual rights and enforce them as if they are personal property interests.

Floating Charges

The revolving capital of a business is comprised in its business activity including its stock and debtors.

The ability of the business to raise funding on the security of its revolving capital is critical for the business.

It follows that the financier to the business should be certain as regards its security over that revolving capital to mitigate risk and provide the finance without a risk premium to the business.

PPS as it applies in New Zealand retains the floating charge but without the associated English law concepts such as of crystallisation and its historical legal concept.

Banks will need to consider this change and the effect on business funding and what, if any, changes will mean in security risk, priority of security as currently exists and the approach of the courts.

Purchase money security interest (PMSI) priority

Under PPS an equipment financier that requires a security over a specific item of equipment acquired by a business and funded by the equipment financier would obtain priority over the holder of a floating charge.

This some argue is the common law position but this is not entirely free from doubt. Academic debate continues.

Commercial transactions require certainty. Asset financiers would gain certainty from PPS perhaps at the expense of working capital financiers. The equipment financier claiming the purchase money security interest priority would be entitled to first right of enforcement of the security despite the effect this might have on the business.

The implications of a clear right to assert a purchase money security in priority to the interests of the holder of a floating chargee that has provided the business working capital financing will require assessment.

Under the New Zealand PPS regime it appears a purchase money security interest in collateral does not have priority over the holder of a floating charge in respect of inventory or intangibles.

Will banks have to take added security positions, review credit risk assessment models, introduce special terms into financing and security documentation etc?

Transitional Arrangements

Obviously a new PPS regime will require a major transition for financiers.

The April 2006 Standing Committee of Attorney Generals Options Paper describes some options for dealing with existing or pre-PPS reform securities lodged in a large number Commonwealth and States and Territories securities.

For large scale financiers such as banks an option that they must re-register their securities as happened in New Zealand would be a major impost and would not be supported by banks.

Also, there are existing PPS interests for which there are no registration facilities.

Whether the new PPS regime operates as a "clean start" with a "grandfathering" process where existing PPS interests expire and are retired and replaced under the new system will require close consultation.

Insolvency

It is assumed existing insolvency law (bankruptcy and corporate law) will apply in the same way to the rights of secured creditors as they do now; that is in general, the rights of the secured creditor (that has perfected its security) is able to proceed to deal with the security unfettered by the insolvency event.

Under the New Zealand PPS Act it seems that a secured creditor must have priority over all other secured creditors before it is able to act on its security. It is unclear why a second ranking secured creditor may not proceed in respect of the same collateral as is the case with real estate securities.

The inclusion of reservation of title clauses under sale contracts as PPSs requiring registration as purchase money securities to obtain priority (and the tracing provisions) could help to remove much uncertainty and litigation in receiverships and insolvency administrations.

The ABA has yet to form its view on this.

Concluding Comment

The ABA has given its "in principle" support to PPS reform and will work with the governments and other interested parties to resolve the many issues ahead.

Australian Bankers' Association

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