Australian Banking Association

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John Sheehy
CEO Pottinger Limited
Sydney
By email john.sheehy@pottinger.com

Dear Sir

Banking Code: Review of the small business definition

The Australian Banking Association (ABA) is pleased to provide the following submission for the purposes of your review of the small business definition in the Banking Code of Practice (the Code).

Australian Banks committed to SME lending

Supporting small and medium enterprises (SMEs) has never been more important. Before the pandemic, SMEs contributed more than a quarter of Australia's GDP and employed almost half of the Australian workforce. If the economy is to recover rapidly from the effects of the COVID-19 pandemic it is critical to ensure the flow of credit and the right regulatory settings for SMEs.

The ABA and its member banks continue to provide support for the initiatives the Australian Government has announced to respond to the challenges of COVID-19. Australia's banks have played a key role throughout the crisis and stand ready to continue helping millions of SMEs as we move from emergency to economic recovery.

Since February 1, Australian banks have provided over $41 billion in loans to SMEs and sole traders. They are lending roughly $2.4 billion a month to SMEs. Approval rates for loans have remained high throughout the crisis, with banks reporting they have approved around 70% of loan applications received. ABA members continue to provide new and tailored support measures to SMEs, be it removing merchant fees, providing new and flexible loan products or deferring business loan repayments to allow SMEs the time to get back on their feet.

Banks are also enhancing their resources for dealing with customer hardship as a result of the pandemic.

In this climate, striking the right balance is important. It appears the Government is seeking to do this in respect of the general regulatory settings for financial services. A key task of the ABA is to ensure that this approach is reflected in the Banking Code of Practice.

Striking the right balance

The ABA believes that the small business definition in the Banking Code of Practice should strike the right balance between ensuring that smaller businesses, who have less access to resources and are more vulnerable to asymmetry in sophistication, knowledge, risk and bargaining power than larger businesses, have the benefit of the protections in the Code. Conversely, larger and more sophisticated business, which are more likely to be in a position to protect their own interests in negotiations in respect of the terms and conditions under which they do business with banks, should not be unduly constrained by the imposition of standard terms and conditions.

In order to meet the more sophisticated, complex and variable needs of larger businesses banks should have flexibility in loan structuring to provide customers with appropriate and bespoke solutions. This is less critical with simpler and more homogenous lending structures typical of smaller businesses which also benefit from the support detailed in the Code.

Setting the right balance in this context will help ensure that businesses of all sizes can obtain the level and protection they need while keeping the flow of credit unimpeded.

Against that background, we set out our detailed views below.

Key points

- The current definition of small business, including the current threshold for total credit exposure (TCE) of $3 million, appropriately reflects the policy intent behind the Code of ensuring small businesses have the benefits of its protections while leaving larger, more sophisticated businesses free to negotiate appropriate conditions with their bank.
    - There is no compelling evidence that supports an increase in the TCE threshold of $3 million
    - The threshold credit amount should remain tied to total credit exposure (TCE) and should not be changed to a 'per facility' basis (in line with the view of the Council of Financial Regulators)
    - A turnover of $10 million is an appropriate marker of business sophistication and should be retained
    - The threshold of 100 full-time equivalent employees should be retained
    - Adjustments should be made to the definition to clarify that all of the above criteria apply at a group level.
- Data collected first by the ABA and then by ASIC show that:
    - Only around 2% of loans provided by banks are to business entities with TCE of $3 million or more
    - Only around 1% of loans are provided to businesses with turnover in excess of $10 million.
- These criteria, like all provisions in the Code, *set minimum standards*. Code subscribers can, and frequently do, in this and other contexts, offer banking services on terms that exceed the minimum standards in the Code – including by not relying on one or more of the criteria for small business or by relaxing threshold requirements.
- Some aspects of the current definition render open the possibility that larger, more sophisticated businesses, which were clearly not intended to be covered by the Code, are technically captured. The Review may consider it appropriate to take this opportunity to recommend adjustments to the definition to ensure it better reflects the intended scope. We provide suggested amendments for your consideration in the body of the submission below.
- If the Review recommends changes to the Code, these should take effect only after an appropriate implementation period to allow subscriber banks to effect changes to documentation, processes, and systems as necessary, review portfolios to identify impacted customers, and provide appropriate training to staff.
    - A period of at least 12 months from the time of any ASIC approval would be preferable, and at least 6 months, necessary.

Definition criteria as minimum standards

At the outset, we think it worth drawing attention to the fact that provisions in the Code are designed to set minimum standards. Code subscribers can, and frequently do, in this and other contexts, offer banking services on terms that exceed the minimum standards in the Code – including by not relying on one or more of the criteria for small business or by relaxing threshold requirements.

For this reason, it is unsurprising that, as some stakeholders have pointed out from time to time, banks do not always apply the criteria in the small business definition in an entirely consistent way. This drives greater competition, whereas uniformity could lead to poorer outcomes for customers as a result of reduced competition and differentiation in the small business lending market.

It should also be recognised that banks have shown flexibility in responding collectively to particular circumstances where necessary. For example, under the ABA's supplementary business relief package (authorised by the ACCC in response to the pandemic), all ABA members effectively agreed to temporarily extend Code benefits to businesses with up to $10 million TCE by agreeing not to enforce business loans for non-monetary defaults, other than as set out in para 80 the Code, up to 30 September 2020 or for the period of loan deferrals, whichever was the later.

In our view, these are important considerations when examining the continuing need for the various limbs of the small business definition in the Code, and it is against that background that we address each of the limbs below.

Turnover

The ABA remains of the view that a $10 million turnover limb is appropriate based on members' experience in dealing with more sophisticated businesses. Retention of this limb is favoured because banks sometimes rely on it to exclude larger firms from Banking Code obligations as there are circumstances where sophisticated large businesses carry little debt and have few employees, and where size and sophistication is betted reflected by turnover. In such cases the turnover limb may be the only factor that reveals the entity for what it is – substantially large and sophisticated.

Finally, we note that data collected by ASIC over the 6 quarters from 1 January 2019 to 30 June 2020 show that only around 1% of loans of ADIs surveyed were to businesses with turnover in excess of $10 million.[1]

Full time equivalent employees

This is an appropriate indicator of the sophistication and financial capacity of an entity (which are relevant considerations in setting a threshold for the application of customer protections in a business/commerce context). Both the Khoury Review and the Hayne Royal Commission recommended the use of this measure – both to have a measure based on full time equivalent employees and that the applicable number should be 100.

Consistent with the proposal to apply the thresholds at group level, the Hayne Royal Commission recommendation also noted that the 100 employee limb should apply to 'any business or group'.[2] [See below section on application of thresholds to groups].

Credit amount: Threshold

Background

The genesis of this review of the small business definition was the exchange between ASIC and the ABA, in the course of our application for approval of the Code under the Corporations Act, on the subject of the appropriate threshold amount, and the criterion to which that should apply – total credit outstanding or 'per facility'.

In particular, there have been calls for the threshold amount to be set at $5 million, and for this to be applied on a 'per facility' basis. This position originated with the recommendations of the Australian Small Business and Family Enterprise Ombudsman in its Inquiry into small business loans of 2016, was adopted by the Independent Review of the Code of Banking Practice, conducted by Phil Khoury in 2017. It was also the subject of a recommendation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (recommendation 1.10).

[1] ASIC data provided to the ABA and Pottinger October 2020.
[2] Recommendation 1.10 – Definition of 'small business' The ABA should amend the definition of 'small business' in the Banking Code so that the Code applies to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than $5 million.

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The issue was then considered by the Council of Financial Regulators in March 2019 who agreed that, on balance, the ABA's proposed $3m total credit exposure threshold was appropriately maintained pending this independent review. The ABA's view is that $3 million TCE remains at this time an appropriate minimum standard for the Code. This threshold is intended to represent a balance between the industry's intention to offer less sophisticated borrowers the additional protections afforded by the Code, with the potential consequences for credit availability, financial stability and competition of lending contracts with limitations on covenants. The reasons for this conclusion are set out below.

Lack of evidence to warrant a move to a threshold of $5 million

The industry remains interested in any evidence that suggests businesses with TCE between $3 million and $5 million are adversely affected by falling outside the definition of small business applied in the Banking code. We (and we understand, ASIC) have enquired with AFCA as to whether their complaints data could offer any insight, but we understand that AFCA does not collect data in a way that would assist in this respect. We understand the AFCA complaints data does not identify if there is a material or systemic concern for businesses between $3 million and $5 million TCE not receiving the protections of the Code. However, we remain open to reviewing any available case studies.

In our view, any change in the threshold should be made only if there is a demonstrated gap in the existing definition. We are unable to identify in the reports by those advocating a change in the threshold a demonstration of any compelling need for change to the threshold. On the contrary, data collected by the ABA and ASIC tend to indicate that the existing Code definition covers a substantial majority of business customers.

Further, we note that some banks comply with the Code in such a way that some or all of the commitments are delivered for a broader group of customers, including by extending Code protections to businesses with up to $5 million TCE. However, the Banking Code represents a minimum standard that is to be applied by all ABA members. This minimum standard may increase over time, but it is currently less than 18 months since the commencement of the $3 million TCE criterion in the 2019 edition of the Code. We are not convinced that the reasons that were accepted by the Council of Financial Regulators for maintaining the current threshold have changed.

During the course of its consideration of the ABA's application for approval of the Banking Code of Practice in 2018, ASIC requested data including the following:

> *What percentage (in terms of both dollar value and customer volume) of the banks' business lending portfolios is made up of businesses with total credit exposures:*
>
> > *Of less than $3 million?*
> >
> > *Of between $3 million and less than $5 million?*
> >
> > *Of greater than $5 million?*

In response, the ABA supplied data provided by the four major banks, three regional banks and two other banks, compiled into the tables reproduced below.

Table 1 – Number of Business Customers

	Less than $3m %	$3m to less than $5m %	$5m and over %
Major banks	98.0	0.8	1.2
Other banks	97.8	0.9	1.3
All banks	98.0	0.8	1.2`

Moreover, the data show that increasing the threshold to $5 million would increase the capture of the Code to only an additional 1% or so of customers. There have been no examples presented to the ABA as to why doing this is necessary or warranted.

Data collected by ASIC over the 6 quarters from 1 January 2019 to 30 June 2020 largely reflect similar results – approximately 98% of loans to small business customers being caught by the existing Code threshold of $3 million TCE.

Maintaining a level playing field

The data the ABA provided to ASIC in 2018 revealed significant differences between major banks and other ABA members, especially when the value of exposures is considered.

Table 2 – Value of Business Loan Exposures

	Less than $3m %	$3m to less than $5m %	$5m and over %
Major banks	22.5	5.3	72.2
Other banks	49.6	8.2	42.0
All banks	23.8	5.4	70.8

This information shows that there are significant differences between the majors and others, with majors recording only 22.5% exposures by value less than $3 million and another 5.3% between $3 million and $5 million. In comparison, the non-majors (dominated by the three regional banks) have a much larger 49.6% less than $3 million and a further 8.2% between $3 million and $5 million.

The major banks have a much higher share of customers with a TCE above $5 million (72.2% versus 42.0%).

For non-major banks, a shift to a $5 million TCE threshold would expose 57.8% of the value of their business loan book to 'covenant-light' contracts - a material increase of 16.5% in the portion of the loan book for these (non-major) banks.

We understand that ASIC will provide updated data to the Review to assess the current position.

Maintaining the right settings for economic recovery

Banks understand and embrace the key role they play in ensuring the flow of credit into the economy. During COVID-19, banks have lent roughly $1.5 billion a week to small businesses and remain committed to supporting small business. This lending has taken place under the current definition of small business in the Code.

If the threshold TCE amount was increased, it is possible that some banks may respond to the resulting reduction in covenants for loans between $3 million and $5 million TCE by being more cautious in granting access to business credit to that class of customer. As set out below, this is particularly the case for smaller banks, where a higher proportion of the business book is covered by the Code.

These kinds of considerations clearly influenced the Council of Financial Regulators when, in its Quarterly Statement of March 2019, it noted:

> "Members discussed the definition of small business in the Banking Code of Practice (the Code). They noted that the changes to the Code already due to commence on 1 July 2019 are significant. Further, the effects of these changes and any response to them by lenders, including small to medium-sized lenders, is still to be gauged. In light of this and the tightening in credit conditions that has taken place, members supported maintaining the current borrowing

> threshold to define small businesses within the Code, with an independent review to be undertaken within 18 months of the Code's commencement."

We would submit that, in the current economic environment, these concerns would remain.

TCE vs 'per facility'

As outlined above, there have been calls for the credit amount threshold to be applied at a 'per facility' rather than a TCE level. We remain of the view that this would not be appropriate. As the ABA has previously stated, prudent credit assessment takes an aggregate view of liabilities. A facility threshold rather than TCE is less consistent with the principles underpinning responsible lending and prudential regulation standards.

Applying the threshold using a per facility basis could also lead to larger, more sophisticated businesses being captured by the definition, which was not the objective intended when the ABA sought to support SME businesses via the ABA Banking Code by adopting a $3 million TCE as the appropriate measure.

Finally, we note that applying this criterion at a TCE level was unequivocally endorsed by the Council of Financial Regulators in its Quarterly Statement of March 2019:

> "Members expressed a view that a limit based on total credit exposures is more appropriate than one based on loan size."

Consistency with prudential framework

For many of Australia's banks, particularly those on APRA's Standardised Approach, a TCE measure is consistent with prudent credit-risk management practices and how Australia's capital requirements and prudential standards are currently applied and supervised by APRA.

Any change in risk profile of a SME loan portfolio due to use of a $5 million per facility threshold could result in banks and regulators responding in different ways to manage the increased potential risk and/or higher capital provisioning.

Increasing the number of loans managed as a "small business" by introducing a $5 million threshold, coupled with limiting the covenants in these loan contracts through the ABA Banking Code, means a larger number of loans originated and managed by banks will be on "retail terms" (similar to consumer/residential lending, than specialised business lending).

To widen covenant-lite lending from a TCE to a per facility threshold could increase the risk profile of smaller banks and creates a disconnect between prudent lending practices and the intent of the capital framework.

Should the test move to a facility threshold rather than TCE measure banks who would wish to offer such lending could be subject to higher capital charges and/or a greater supervision intensity by APRA should their risk profile alter. A consequence of this would be for that ADI to not to allocate capital to facilitate lending in that SME market (to lower their overall risk profile), thereby lessening competition.

For those banks that continue to offer SME loan products under an altered definition, the increased risk could impact banks' risk appetite such that they alter their SME product offering in such ways as loan size limits, loan terms (i.e. principal and interest payments, lower LVR, and higher cash requirements), shorter loan tenor and stricter security requirements, etc. This would not be an optimal outcome for SME customers.

Alignment with government objectives

The Government has announced changes to the National Consumer Credit Protection Act to exclude all business lending from its scope, in order to “enable lenders to lend to small business confidently, further supporting businesses as Australia recovers from the COVID-19 pandemic.”[3]

The Government has also announced time-limited tax incentives, including the temporary full expensing and loss carry-back measures. This will generate investment activity by lowering the cost of investment for a limited time period.

Maintaining the existing settings in the small business definition would, in our view, be consistent with these objectives as part of an overall approach to address the effects of the pandemic by ensuring regulation is streamlined.

Application of thresholds to corporate groups vs individual entities

Currently, the definition of small business lacks clarity in that it can be interpreted as providing that, while the TCE threshold is applied at the corporate group level, the FTE and turnover limbs are applied at the individual entity level.

In our view it is appropriate that all three limbs apply at the group level and this should be clarified to remove any ambiguity. Applying the definition as a whole at group level is consistent with the recommendation of the Hayne Royal Commission which refers to “any business or group employing fewer than 100 full-time equivalent employees…”[4]

In our view this was the intention of the small business definition but this may not be clear on the current drafting.

Ensuring the definition appropriately distinguishes between small businesses and larger, more sophisticated businesses

In our view, the intention of the Code – to appropriately define and capture what are, in substance, small businesses, should not be undermined by unintended results flowing from certain business types or structures. A key example is entities that form part of a corporate group. This is why the TCE threshold in the definition is expressed to apply to the debt of the entity and its related entities that are businesses.

However, the current wording of the definition does create ambiguity around whether entities structured in certain ways, and which in our view should clearly fall outside the concept of small business under the Code, are in fact captured.

The types of entities referred to here fall into two categories – non-corporate structures in general, and certain customers of institutional banks.

Non-corporate structures generally

As the current definition focusses on ‘related entities’, some unincorporated structures will not be dealt with appropriately. This could include, for example, trusts, partnerships, and joint ventures in which parties are in substance acting in concert but are not ‘related entities’ within the meaning of that term in The Corporations Act.

Examples include:

> <u>Joint venture</u>
>
> ABC Pty Ltd has TCE of $0.
>
> ABC enters a joint venture as a junior partner with XYZ Limited, which is organised around an SPV – QRS Pty Ltd - which has TCE of $20 million.

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[3] https://budget.gov.au/2020-21/content/jobmaker.htm#twenty
[4] See Final Report, Volume 1, recommendation 1.10.

ABC seeks to borrow $2.9 million towards the joint venture.

Any borrowing by QRS would not be covered by the Code but ABC's borrowings are, under the current definition, covered by the Code as neither XYZ nor QRS is a 'related entity'.

Partnership

Jill, a partner in Smith & Associates, a top tier international law firm structured as a partnership, seeks to borrow $2 million to contribute to the equity of the partnership.

Despite borrowing for the purposes of a highly sophisticated and parge professional partnership, Jill is treated as a 'small business' under the current definition in the Code as the TCE, employee numbers or turnover of the partnership cannot be taken into account.

We think this issue could be addressed by adjusting the definition so that groups were defined to include the customer and their 'associates', and for that term be defined to include both related entities and:

> "any company, trust, partnership or joint venture in respect of which the customer is a director, trustee, partner, joint venturer, majority shareholder or majority beneficiary."

Institutional bank customers

Problems with the current definition are frequently encountered within the institutional divisions of banks. Table 3 below outlines other situations in which large or highly sophisticated businesses, or entities within them, who are customers of institutional banks, may not be appropriately excluded under the current definition.

Table 3 – Institutional bank customers and the Code

Customer Type	Description	TCE $3M to Credit Providers	100 FTE / 10M Turnover
Banks	Sophisticated entities, granted banking licences and subject to strict regulation, including minimum knowledge and experience requirements.	Debt is often to deposit holders, not to 'credit providers'.	Entity level test may not be passed for all subsidiaries.
Fund Managers	Manage several millions of dollars as trustees on behalf of beneficiaries.	Do not have significant levels of debt.	Do not have significant levels of turnover or employees.
Funds	Regulated in their own right or operated by a fund manager who is regulated, and have a high degree of financial sophistication, as per AFSL holders.	Do not have significant levels of debt.	Do not have significant levels of turnover or employees.
Public sector entities e.g. central banks, governments	Manage millions/billions of dollars at a group level.	Often do not have significant levels of debt.	Do not have significant levels of turnover or employees.
Listed entities	Listed on the ASX - demonstrating a high level of corporate governance and sophistication.	Often do not have significant levels of debt.	Entity level test may not be passed for all subsidiaries.
Large Corporates	Sophisticated entities with large balance sheets, and often global organisations.	May have large debts, however often to bond or note holders rather than to 'credit providers'.	Entity level test may not be passed for all subsidiaries.

We think this issue could be addressed by:

- Expressly excluding companies listed on the ASX, government entities, and Australian Financial Services Licensees that are authorised to operate registered managed investment schemes as a responsible entity or to provide custodial and depository services (fund managers / funds); and

- Ensuring that the credit amount threshold includes debts owed to deposit, bond or note holders, where relevant (this will capture banks and large corporates).

Proposed adjustments to the definition

Set out below are our proposed adjustments, consolidated into a revised definition. To more accurately reflect the intent behind the definition, we suggest that the Review may find it appropriate to recommend these amendments:

What is a "small business"?

A business is a "small business" if at the

time it obtains the banking service, it (together with its associates that are businesses) ~~all of the following apply~~:

a) ~~it~~ had an annual turnover of less than $10 million in the previous financial year; and

b) ~~it~~ has fewer than 100 full-time equivalent employees; and

c) ~~it~~ has less than $3 million total debt to all credit providers (or, where relevant, to deposit, bond or note holders) including:

i. any undrawn amounts under existing loans; and

ii. any loan being applied for. ~~; and~~

~~iii. the debt of all its related entities that are businesses.~~

"associate" means:

(a) any related entity of the customer; and

(b) any company, trust, partnership or joint venture in respect of which the customer is a director, trustee, partner, joint venturer, majority shareholder or majority beneficiary.

However, a business is not a "small business" if it is a company listed on the Australian Stock Exchange, a government entity, or an Australian Financial Services Licensee that is authorised under its licence to operate registered managed investment schemes as a responsible entity or to provide custodial and depository services.

Timing of any proposed changes

An appropriate implementation period is required in order to operationalise and implement any significant changes to the Code. This is necessary, for example, to effect changes to documentation and processes, review portfolios to identify impacted customers, and provide appropriate training to staff.

In addition, in our view the Review should consider whether any change to the current settings for lending under the Code are warranted or desirable in the current economic environment, and whether any changes should be deferred for an appropriate period to account for the period necessary for the economy to recover from the effects of the pandemic.

In our view, a period of at least 12 months from the time of any ASIC approval would be preferable, and at least 6 months, necessary.

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Please feel free to contact me if you should wish to discuss any of the matters outlined above.

Yours sincerely

Jerome Davidson
Director, Legal Affairs
(02)8298 0419
jerome.davidson@ausbanking.org.au