



# Australian Banking Association

07 March 2019

Mr Philip Lowe  
Governor  
Reserve Bank of Australia  
65 Martin Place  
Sydney NSW 2000

Via email

Dear Governor Lowe

## 2019 ABA Banking Code of Practice

I am writing to you in your capacity as Chair of the Council of Financial Regulators to update you on the work the Australian Banking Association (ABA) is undertaking regarding the Royal Commission (RC) recommendation 1.10 - *Definition of small business* and to highlight concerns about the potential consequences of the ABA adopting, in verbatim, the RC recommendation into a revised 2019 ABA Banking Code of Practice (**Code / 2019 Code**).

The ABA Code is unique to ABA banks, and the small business chapter is entirely new. From 1 July 2019 it will offer a level of support and protection to small business never available before. The design and finalisation of the Code was the subject of an independent review, extensive stakeholder consultation and took nearly 18 months to finalise. On 31 July 2018, ASIC approved the Code under section 1101A of the *Corporations Act 2001*, after satisfying themselves that the definition applied the protections of the Code to the vast majority of small business customers who would significantly benefit from those protections.

The relevant small business definition in the ASIC approved Code is in Chapter 1 and specifies:

*"A business is a "small business" if at the time it obtains the banking service all of the following apply:*

- a) it had an annual turnover of less than \$10million in the previous financial year; and*
- b) it had fewer than 100 full-time equivalent employees; and*
- c) it has less than \$3 million total debt to all credit providers including:
  - i. Any undrawn amounts under existing loans;*
  - ii. Any loan being applied for; and*
  - iii. The debt of all its related entities that are businesses."**

For those businesses eligible for the protections of the Code, the protections are spelt out in chapter 20. For example, clause 80 outlines the specific circumstances in which a non-monetary default enforcement action can be taken. These specific circumstances exclude enforcement terms which are currently standard in business loan contracts such as changes to loan to value ratio and material adverse changes to the business and are therefore now regarded as 'covenant-light' contracts. The Code includes changes designed to meet the recommendation of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) to remove conditions where banks can unilaterally value existing security assets during the life of a loan or invoke financial covenants or catch-all 'material adverse change' clauses. These new Code provisions and protections are designed to recognise that many small businesses could be considered unsophisticated borrowers, more akin to retail customers.

As a condition of their approval of the Code, ASIC required banks to commence an independent review of the definition of small business within 18 months of the new Code's commencement to assess the suitability of the \$3 million TCE threshold in the definition. In preparation for that review, ASIC is requiring ABA banks to provide them with periodical data in relation to small business disputes.



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The Royal Commission has proposed in Recommendation 1.10 that:

**“The ABA should amend the definition of “small business” in the Banking Code so that the Code applies to any business or group employing less than 100 full time equivalent employees, where the loan applied for is less than \$5 million.”**

The text of the RC recommendation is drafted in a way such that it expands the application of the Code small-business covenant-light contracts well beyond the small business sector. It extends the Code protections to significantly larger exposures and more complex entities traditionally funded by the institutional arms of banks. Specifically, the recommendation proposes to move the definition of small business from a \$3 million total credit exposure (TCE) to an aggregated uncapped credit limit as long as each additional credit facility is less than \$5 million, while at the same time implying the removal of the \$10 million turnover limb of the definition, which is intended to confine the Code to genuine small Australian businesses.

The ABA is deeply concerned about the proposed move to an aggregated uncapped credit limit where each credit facility is less than \$5 million, as:

- 1) The current Code definition will cover the vast majority of small businesses in Australia. The ABA submitted the Code to ASIC with a \$3 million TCE, as our data (see attachment) shows, 98% of business customers of all major and regional banks have TCE less than \$3 million, with another 0.8% of business customers having TCE of between \$3 million and \$5 million. There is little difference between major banks and the regional banks on the number of business customers captured by these thresholds.
- 2) At a \$3 million TCE threshold, the data shows that 23.8% of the bank business lending by value would be exposed to covenant-light contracts (figure 3). However, there is a significant difference between major and regional banks regarding the amount of lending captured by value. Majors have 22.5% of their business loan book exposed by value less than \$3 million and another 5.3% between \$3 million TCE and \$5 million TCE (figure 6). In comparison the regional banks have a much larger 49.6% less than \$3 million and a further 8.2% between \$3 million and \$5 million (figure 6). 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. This difference is considerably magnified if an uncapped credit limit is applied.
- 3) ABA data shows a move beyond the \$3 million TCE cap in the 2019 Code towards the RC recommended definition could then subject the remaining 76% (figure 2) of ABA banks business loan exposures (estimated at \$706bn) to covenant-light lending. This is in a situation where a borrower has existing debt, beyond the new <\$5 million facility sought.
- 4) A new facility in this scenario would be effectively subordinated to the existing debt. Subordination of this new covenant-light exposure to the existing exposures (both secured and unsecured) significantly increases the risk profile of this new business lending in a way which may not be in the prudent risk appetite of any bank.
- 5) \$3 million TCE threshold represents a manageable level of credit risk for medium and small banks such that they will continue to be able to compete with larger banks and non-bank lenders. ABA data on the business loan exposures of ABA banks demonstrates that the \$3 million TCE threshold is appropriate to avoid restricting competition in the SME lending area.
- 6) The \$3 million TCE also avoids the possibility of large or international business with multiple loan facilities (each facility being less than \$5 million) across multiple financial institutions (bank and non-bank lenders) then availing themselves of the covenant-light protections under the ABA Code; protections that are designed and intended for small businesses only. There are many examples where large or international businesses have fewer than 100 full-time equivalent employees in the Australian entity.



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- 7) The ABA analysis shows that a change to the TCE threshold will have a disproportionate impact, by value of exposures, on the prudential credit risk profile of non-major banks. This is particularly important for those small lenders who offer specialised lending to a certain small business sector (e.g. dentists), particularly those where that specialised lending may be geographically concentrated (e.g. arable farmers), as increased prudential risk would be avoided.

The ABA is concerned that a verbatim application of the RC recommendation will have detrimental implications for the supply of appropriate credit to small business. This would defeat the original purpose and intent of the ABA Code which was to offer simplified small business loan contracts with fewer conditions for the vast majority of small businesses in Australia.

The attachment to this letter outlines the history of the small business section of the 2019 Code along with the origins of the \$5 million and data on bank lending portfolios as of June 2018. This data was the empirical basis of the ABA settling on a \$3 million TCE as being the most appropriate measure of a small business in the ASIC approved Code.

The ABA has publicly released<sup>1</sup> its response to the RC Final Report in which we accept all recommendations we are required to implement, apart from recommendation 1.10, on which we are yet to form a final view. The ABA believes that the implications of this recommendation need to be fully understood, particularly considering the possible impact of this recommendation on prudential strength, credit risk management, supporting competition and the supply of appropriate credit to meet the needs of small business borrowers.

The RC recommendation does not specify an implementation date for any changes to the ABA Code. The ABA intends to implement the accepted RC changes as quickly as possible. However, given the potential impacts and the newness of the small business protections in the Code, the ASIC mandated independent review of the definition of small business within 18 months of commencement may be the appropriate time and mechanism for assessing the prudent operation of the small business section in the ABA code against the objectives of the RC recommendation. At this time, any changes could be considered based on the empirical data currently being gathered.

As the ABA works to finalise our position on RC recommendation 1.10, the ABA would value the views of the Council of Financial Regulators.

Please don't hesitate to contact me if you require any further information.

Yours sincerely

A handwritten signature in blue ink that reads "Anna Bligh". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Anna Bligh  
Chief Executive Officer  
Anna.Bligh@ausbanking.org.au

Encl.

<sup>1</sup> <https://www.ausbanking.org.au/media/media-releases/media-release-2019/banking-code-shakeup-after-royal-commission-final-report>





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## Attachment A

### 2019 ABA Banking Code of Practice

This document outlines the history of the Small Business Section of the 2019 ABA Banking Code of Practice (**Code / 2019 Code**) which in its current form will require ABA members to offer simplified small business loan contracts with fewer conditions for the vast majority of small businesses in Australia.

This attachment contains quantitative analysis on why the \$3m total credit exposure (TCE) is the appropriate measure of a small business and ensures ABA members can offer simplified small business loan contracts to appropriate businesses while minimising unnecessary credit risk for medium and small banks such that they will continue to be able to compete with other larger banks and non-bank lenders and provide the credit small business needs.

#### Background

In July 2018, ASIC approved the revised ABA Banking Code of Practice which comes into effect on 1 July 2019. The code contains an entirely new section for Small Business lending.

The code provisions apply to a Small Business which is defined as:

*"A business is a "small business" if at the time it obtains the banking service 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 including:
  - i. any undrawn amounts under existing loans;*
  - ii. any loan being applied for; and*
  - iii. the debt of all its related entities that are businesses."**

In February 2019, the Royal Commission (RC) made a recommendation (1.10) that:

*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.*

The ABA is deeply concerned about the proposal to move to an aggregated uncapped credit limit where each credit facility is less than \$5 million.

#### Banks' business lending portfolios

In June 2018, the ABA collected business loan exposure data from nine banks. Across these banks, there were 1.6 million business customers. It is important to note that if a customer has loans with more than one bank, this will inflate the *customer number* data. A total of \$927 billion of exposures was reported by the nine banks, averaging \$580,960 per customer.

Applying the EDR Review principles of including the "substantial majority of small business" ABA data indicates that 98% of all business customers have total business lending of less than \$3 million TCE.

The below tables outline some of the data ABA provided to ASIC in July 2018 to demonstrate that a \$3 million TCE threshold is appropriate. The purpose of the ABA data was to highlight our concerns with stakeholder proposals to move the Code definition from \$3 million TCE to \$5 million TCE. The data still remains salient to ABA concerns about the proposed move to an aggregated uncapped credit limit where each credit facility is less than \$5m, as per the RC recommendation.





**Figure 1 – Number of business customers**

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

**Figure 2 – Value of business loan exposures**

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

The data shows that 98% of the number of customers of all banks have total credit exposures less than \$3 million, with another 0.8% of customers having TCE of between \$3 million and \$5 million (figure 1). There is little difference between major banks and the other banks on the number of customers covered.

Looking at the value of exposures, 23.8% of the value of TCE for all banks are less than \$3 million, with another 5.4% with TCE of between \$3 million and \$5 million (figure 2).

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, while 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% versus 42%). 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 change from a \$3 million to \$5 million TCE would represent a material increase of 16.5% for these (non-major) banks. A further move to an aggregated uncapped credit limit (as per the RC recommendation) where each credit facility is less than \$5m would compound that already increased credit risk for both major and non-major banks as the major banks have significantly more exposures that are of high value.



Business loan exposures

Figure 3 – Banks’ business loan exposures: summary data

All banks	Total Credit Exposure of:			Total
	Less than \$3m TCE	\$3m to <\$5m TCE	\$5m and over TCE	
Number of customers	1,563,726	13,020	18,882	1,595,626
Total Credit Exposure (\$)	\$220,521,989,854	\$50,086,539,921	\$656,295,265,823	\$926,994,289,604
<b>Distribution</b>				
Number of customers	98.0%	0.8%	1.2%	100.0%
Total Credit Exposure (\$)	23.8%	5.4%	70.8%	100.0%
Average	\$141,023	\$3,846,892	\$34,757,720	\$580,960

A breakdown of the data by amount of exposure shows that 98% of customers have an exposure of less than \$3 million TCE which accounts for 24% of the total value of exposures.

The RC asserted that shift to a \$5 million per loan threshold “would have a relatively small effect, extending coverage of the provisions to another 10,000 to 20,000 businesses.” The ABA data shows a move from \$3 million TCE to \$5 million TCE would bring in another 13,020 customers under the protections of the Code. The sum of total credit exposure of these additional customers is 5.4% of the business loan book of the nine banks that provided data to the ABA. An averaging of the exposures under \$3 million TCE and \$5 million TCE shows a significant jump in dollar value, that jump is even more pronounced at \$5 million TCE and over.

Customers with a TCE of \$5 million and over represent just 1.2% of the customer base, but the sum of their credit exposure represents 70.8% of the business loan book at \$656 billion. The ABA is deeply concerned about the proposed move to an aggregated uncapped credit-limit where each credit facility is less than \$5 million, and on this sole point respectfully disagrees with the Commissioner’s view that such a change would have a relatively small effect.

In February 2019, the ABA issued a data request to member banks in an attempt to quantify the number of customers with an existing TCE >\$5 million, who also have one or more loan facilities below \$5 million. Given the short timeframe, banks were unable to provide consistent data due to the current constructs of their individual systems, the ABA will continue to work with the banks to see if a wider data set can be produced.

However, one major bank was, with confidence, able to confirm for their business customers with an existing TCE >\$5 million, that 93% of customers in their Institutional Banking book had one or more facilities less than \$5 million and could therefore be captured under the proposed RC definition. The data showed that just 229 customers (7%) in the Institutional Banking book of that major bank fell outside the proposed RC definition of a small business.

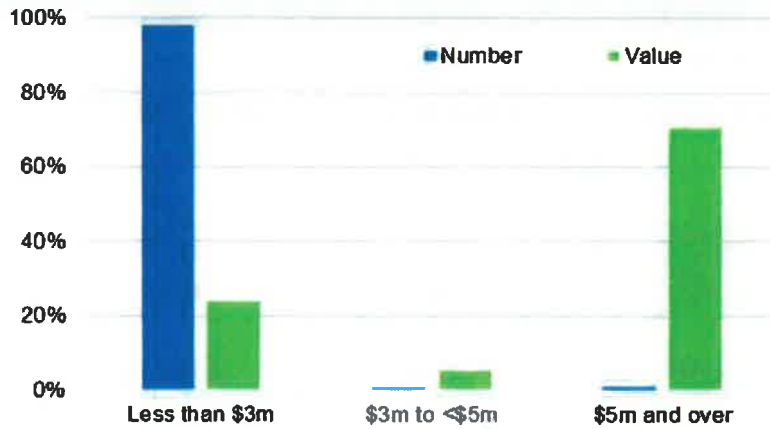
The ABA Code was never intended to provide Institutional Banking customers with those special protections specifically designed for small business customers.

Once this major bank applied the proposed RC test across their entire Business Loan Portfolio, 99.91% of their customers were captured under the proposed RC definition of a small business.



**Business loan exposures of the major banks and other banks**

**Figure 4 – Distribution of banks' business loan customers and value of exposures by level of exposure**



Major banks have 93% of customers and 95% of exposures. For exposures under \$3 million, major banks have 93% of customers but the exposure level falls to 90%.

**Figure 5 – Business loan exposures by major/other banks**

	Total Credit Exposure of:			
	Less than \$3m	\$3m to <\$5m	\$5m and over	Total
<b>Number of customers</b>				
. Majors	1,460,587	12,076	17,557	1,490,220
. Others	103,139	944	1,325	105,406
	93.4%	92.7%	93.0%	93.4%
	6.6%	7.3%	7.0%	6.6%
<b>Exposures - value</b>				
. Majors	\$198,924,268,642	\$46,522,106,443	\$638,002,770,521	\$883,449,145,605
. Others	\$21,597,721,212	\$3,564,433,478	\$18,292,495,302	\$43,545,143,999
	90.2%	92.9%	97.2%	95.3%
	9.8%	7.1%	2.8%	4.7%

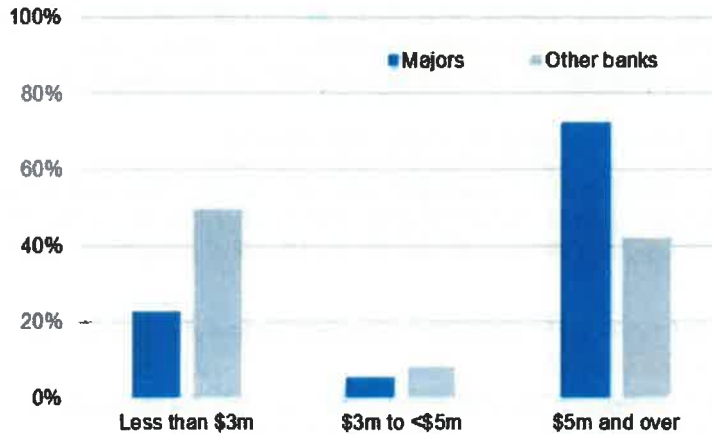




Figure 6 – Banks business loan exposures by major/other bank: summary data

	Total Credit Exposure of:			Total
	Less than \$3m	\$3m to <\$5m	\$5m and over	
<b>Number of customers</b>				
. Majors	1,460,587	12,076	17,557	1,490,220
. Others	103,139	944	1,325	105,406
. Majors	98.0%	0.8%	1.2%	100.0%
. Others	97.8%	0.9%	1.3%	100.0%
<b>Exposures - value</b>				
. Majors	\$198,924,268,642	\$46,522,106,443	\$638,002,770,521	\$883,449,145,605
. Others	\$21,597,721,212	\$3,564,433,478	\$18,292,495,302	\$43,545,143,999
. Majors	22.5%	5.3%	72.2%	100.0%
. Others	49.6%	8.2%	42.0%	100.0%

Figure 7 – Value of business loan exposures by major/other bank by exposure



### The origins of the \$5 million figure

At the time the ABA submitted the Code for approval to ASIC there was a debate about a \$3 million TCE versus a \$5 million TCE threshold in the definition of small business. These ABA and ASIC discussions relating to the appropriate size of a small business credit facility were triggered by a Financial Ombudsman Service (FOS) consultation on expanding its small business jurisdiction in August 2016<sup>1</sup>. At that time, FOS proposed to increase its jurisdiction so more small businesses could access External Dispute Resolution (EDR) and increase the compensation cap for claims in a Small Business/Consumer Finance disputes (SBCF).

<sup>1</sup> <https://www.fos.org.au/custom/files/docs/fos-small-business-consultation-paper.pdf>



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Following the announcement of the Review of the External Dispute Resolution Framework<sup>2</sup> by Professor Ian Ramsay (**Ramsay Review**), FOS deferred amending its small business jurisdiction and made submissions<sup>3</sup> to the EDR Review proposing a small business jurisdiction for AFCA as follows:

1. compensation cap for a claim in a SBCF dispute to \$1 million, with support for increasing to \$2 million,
2. credit facility limit for a debt-related SBCF dispute to \$5 million, with support for increasing to \$10 million,
3. matters beyond \$2 million and \$10 million are of a size and character generally more suited to resolution in the civil jurisdiction of the courts.

FOS' submissions were based on data analysis prepared by FOS and KPMG<sup>4</sup>.

The Australian Small Business and Family Enterprise Ombudsman (**ASBFEO**) Inquiry into Small Business Loans<sup>5</sup> and the Khoury review of the 2013 Code of Banking Practice adopted this FOS position of a \$5 million limit.

The final recommendation of the Ramsay Review was:

- monetary limit of \$1 million and a compensation cap of no less than \$500,000
- small business credit facility is of an amount up to \$5 million<sup>6</sup>.

The Government accepted that recommendation as part of the 2017 Budget package.<sup>7</sup>

Importantly, the thresholds were determined to support the EDR Review's principle that *"the substantial majority of small business disputes should be able to be resolved by the EDR body"* and that *"the monetary limits and compensation caps should reflect general economic indicators and the levels of credit facilities and financial products held by small businesses."*<sup>8</sup>

The ABA has always held the view that the FOS research had very different objectives, its purpose was to determine the size of a business able to have matters heard at EDR and was never a suitable analysis to be used to ascertain the appropriate credit risk threshold/exposure amount for those additional protections and covenant light small business loans in the ABA Code.

### FOS analysis behind their proposed \$5 million threshold

The ABA does not accept that there is any reliable basis for the development of the \$5 million figure. On ABA analysis, the original work of FOS/KPMG is flawed in several respects. The fact that others, such as Khoury, ASBFEO and AFCA have so readily relied, without question, upon a flawed analysis does nothing to validate it.

ABA has three primary concerns with using the FOS analysis to support a \$5 million TCE threshold for small business loan facilities, namely:

1. The validity of the underlying assumptions in the analysis, for example, implying business profit and business turnover based on the size of loan facility.
2. The premise of the analysis where FOS sought to identify a loan facility size based on 100 FTE as the benchmark.
3. The assumption that analysis to underpin the AFCA jurisdiction, is suitable empirical analysis to support a prudent credit risk management threshold for additional loan protections for small business.

<sup>2</sup> <https://treasury.gov.au/review/review-into-dispute-resolution-and-complaints-framework/>

<sup>3</sup> p25, [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_Financial-Ombudsman-Service-Submission.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_Financial-Ombudsman-Service-Submission.pdf)

<sup>4</sup> See Appendix D, [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_Financial-Ombudsman-Service-Submission.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_Financial-Ombudsman-Service-Submission.pdf)

<sup>5</sup> [http://asbfeo.gov.au/sites/default/files/030217-ASBFEO\\_Report.pdf](http://asbfeo.gov.au/sites/default/files/030217-ASBFEO_Report.pdf)

<sup>6</sup> p16, [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_EDR-Review-Final-report.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_EDR-Review-Final-report.pdf)

<sup>7</sup> <https://cdn.tspace.gov.au/uploads/sites/72/2017/05/MR044b.pdf>

<sup>8</sup> p169, [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_EDR-Review-Final-report.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_EDR-Review-Final-report.pdf)



### **Underlying assumptions**

The ABA analysis of the underlying assumptions in the FOS/KPMG analysis shows several flaws. In this work there are inconsistencies in the implied data used to determine the business credit facility limits under the sections titled: findings and insights<sup>9</sup>. For example, in the FOS analysis the implied business revenue for a \$5 million facility is \$21,773,343, which is more than double the \$10 million threshold applied in the Code. If this implied data was to be relied upon, the ABA would hold that in reality a \$3 million facility is more aligned to a \$10 million turnover.

### **Premise of 100 employee test**

In developing the analysis, FOS/KPMG looked to ensure coverage of small businesses with 100 FTE (adopting the ASBFEO definition), and conducted analysis to identify an implied, standard credit facility size that aligns with a business with 100 FTE. The ABA considers that starting with the 100 FTE threshold and working backwards is the wrong way to identify the loan facility size, particularly given trends in casualisation of the workforce. The ABA notes that the final report of the EDR review stated<sup>10</sup> that the definition of small business should remain at 20 FTE given this covers 98% of businesses.

### **Purpose and intent of FOS analysis**

The FOS analysis was prepared to support arguments to increase the size of monetary compensation caps and expand the jurisdictional limit for AFCA small business credit disputes. This was in line with the principles that most small business disputes should go to EDR. The ABA is firmly of the view that the determining the appropriate limit whereby a business can access EDR is an entirely different exercise to making credit assessments and determining contract terms for that credit. Relying on the logic used for the former to determine the latter is fundamentally unsound.

### **Conclusion**

The small business chapter of the new Code contains many new protections and entitlements. At a definition of \$3 million TCE a significant proportion of the value of the business lending books of banks will be exposed to covenant-light contracts. In the case of non-major banks, almost half of their business lending book will be exposed. This is an unprecedented situation. Given the unknown impacts on prudent credit risk management, competition and access to credit for small business, any change beyond the \$3 million TCE threshold should be approached with care and caution.

<sup>9</sup> p8, Appendix D, [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_Financial-Ombudsman-Service-Submission.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_Financial-Ombudsman-Service-Submission.pdf)

<sup>10</sup> [https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002\\_EDR-Review-Final-report.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/R2016-002_EDR-Review-Final-report.pdf) (Page 171, paragraph 8.75)

