Australian Government

The Treasury

FINANCIAL SERVICES ROYAL COMMISSION

SUBMISSION

HEARINGS ON SMALL AND MEDIUM ENTERPRISES

INTRODUCTION

1. This submission is directed to three topics arising from questions posed by Counsel Assisting the Royal Commission as part of the third round of hearings. The submission responds to those questions that Treasury considers have broad implications for the regulatory framework for business lending or may have a significant impact on access to finance. These questions concern:

    - Should any of the provisions of the *National Consumer Credit Protection Act 2009* (NCCPA) which apply to consumer credit contracts also apply to small and medium business credit contracts? If so, why and to which small and medium business customers? If not, why not?

    - Is it appropriate for a bank to take enforcement action when non-monetary defaults have occurred and the bank can rely only on non-monetary defaults? Why or why not? Should there be some additional protection for borrowers in these circumstances and ought the bank be obliged to explain matters?

    - The role of codes of practice in protecting recipients of credit, including small businesses.

2. This submission outlines Treasury's approach to determining the circumstances when regulatory interventions are appropriate and the considerations that determine the approach to such interventions.[1] Broadly, regulatory interventions seek to address observed market failures, such as those created by information asymmetries, where the benefits of doing so outweigh the costs.[2] While simple in principle, such considerations often include assessing and carefully balancing competing objectives.

3. As highlighted in Treasury's information note to the Royal Commission on reforms to small business lending, small and medium enterprises (SMEs) make up a significant part of the Australian economy.[3] Australia has more than two million small and medium enterprises, accounting for more than 65 per cent of private sector employment.[4] External finance plays an important role in providing small businesses with the funds they need to grow and create jobs.

4. Regulatory interventions, in this context, have sought to balance the objectives of improving access to finance for these businesses and ensuring appropriate protections — where the benefits of doing so have been seen as exceeding the potential downsides of reduced access and higher cost of credit.

---

1 Treasury's information note to the Royal Commission on the overview of the regulatory framework for the Australian Financial System provides a more detailed discussion on such considerations.

2 Information asymmetry happens when one party to a transaction has access to better information than the other party.

3 The hearings and questions covered both small and medium enterprises. As noted in *Background Paper 12: Financial services and Small and Medium-Sized Enterprises*, the definitions of what constitutes a small or medium sized businesses differs across the regulatory framework. The terminology of SME is used throughout the submission, unless the data or regulatory implication has specific application to small businesses only.

4 Australian Small Business and Family Enterprise Ombudsman, 2016, *Small Business Counts – Small Business in the Australian Economy*, available: **http://www.asbfeo.gov.au/sites/default/files/Small_Business_Statistical_Report-Final.pdf.**

5. The importance of the issues around access and pricing of finance for SMEs is evidenced by the current work being undertaken by the Productivity Commission in its inquiry into Competition in the Australian Financial System and the Australian Small Business and Family Enterprise Ombudsman's (ASBFEO) Affordable Capital for SME Growth Inquiry.[5]

6. Recent Government reforms have sought to address these issues of finance access and pricing by strengthening competition, most notably through improving the availability of data for lenders to small businesses by mandating comprehensive credit reporting (CCR) and establishing an open banking regime. Improved data availability should make it easier for new credit providers to enter the market and expand, and also directly improve pricing and availability of credit by increasing credit providers' ability to assess a small business's credit risk.

7. In addition, the outcomes of the ASIC and ASBFEO review of small business loan practices, announced in August 2017, have led to changes in the credit contracts of the four major banks which eliminate unfair contract terms for loan contracts of up to $1 million. ASIC provided evidence to the Commission that they are continuing to review contracts in the broader financial services industry for unfair contract terms.[6]

8. In our responses to the three questions outlined above, our assessment takes the approach of considering the evidence of market failure and the drivers and, where market failures are evident, sets out considerations for the Commission in assessing the impact and options for regulatory interventions.

9. Treasury would welcome further opportunities to assist the Commission in considering these and other policy issues as the Commission develops its views and recommendations.

5 Productivity Commission, January 2018, *Competition in the Australian Financial System – Draft Report*, available: **https://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf**; Australian Small Business and Family Enterprise Ombudsman, April 2018, Affordable Capital for SME Growth, Terms of Reference, available: **http://www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-affordable-capital-ToR.pdf**.

6 ASIC.0902.0007.009, Witness statement of Michael Saadat, page 36, para 73(b).

NATIONAL CONSUMER CREDIT PROTECTION ACT 2009 (NCCPA) AND SMALL BUSINESS LENDING

CURRENT REGULATORY FRAMEWORK

10. Under the current regulatory framework, providers of SME credit are prohibited from certain conduct in relation to the provision of a financial service.[7] The *Australian Securities and Investments Commission Act 2001* (ASIC Act) includes prohibitions on:

    - unconscionable conduct;[8]
    - misleading and deceptive conduct; and
    - unfair contract terms (for certain standard form contracts).[9]

11. These ASIC Act prohibitions apply, amongst other situations, where a financial services institution provides credit only for business purposes and no requirements exist for these institutions to obtain a licence under the NCCPA. These institutions are referred to as unlicensed credit providers in this submission.

12. The vast majority of credit is provided by authorised deposit-taking institutions (ADIs), in particular the four major banks.[10] In addition to the ASIC Act provisions outlined above, ADIs are subject to the NCCPA (in respect of their consumer credit activity) and authorisation by the Australian Prudential Regulation Authority (APRA) under the *Banking Act 1959*, which includes requirements in relation to their systems, processes and governance frameworks.[11] A subset of ADIs also subscribe to the Code of Banking Practice.

13. Unlicensed credit providers reflect a small but growing segment of the market for credit to SMEs.[12] Unlicensed credit providers generally provide unsecured lending to SMEs and act as a source of competitive pressure on ADIs and other credit providers.

7 Financial service is defined to include the provision of a financial product, which in turn includes a credit facility. A credit facility is further defined by the *Australian Securities and Investments Commission Regulations 2001*; this includes credit provision to small businesses.

8 Excludes listed public companies with the same meaning as the *Income Tax Assessment Act 1997*. The *Treasury Laws Amendment (Australian Consumer Law Review) Bill 2018* currently before Parliament seeks to remove this exemption.

9 Standard form contracts are defined in Section 12BK of ASIC Act.

10 Connolly and Jackman, 2017, *Availability of Business Finance*, RBA Bulletin, December Quarter 2017.

11 APRA's regulation of ADIs is focused on depositor protection and the stability of the system from the risk that borrowers may pose.

12 This is occurring across a range of products and lenders, including e-commerce companies, see discussion in Productivity Commission, *Competition in the Australian Financial System* – Draft Report, pp264-266.

14. In considering whether it is appropriate to extend the application of the NCCPA to providers of credit to SMEs, it is useful to assess what gaps exist in the framework for the two broad categories of credit providers (ADIs and unlicensed credit providers) and whether the NCCPA would effectively address those gaps in a way where the costs of additional regulation would be balanced against beneficial outcomes for SME consumers. For example, recent work done by ASBFEO points to transparency and disclosure as key issues in the unlicensed credit provider market.[13] However, imposing disclosure requirements through regulation would create additional costs for lenders.

Requirement to hold an Australian Consumer Credit Licence

15. The starting point for regulation of financial services and products is the requirement for entities to hold a licence (or authorisation) prior to providing those services or products. This creates a regulatory perimeter, within which protections can be offered to consumers through creating obligations on licensees, and penalties imposed for failing to appropriately meet those obligations.

16. The licensing regime contained in the NCCPA was introduced to standardise regulation across Australia through requiring that providers of consumer credit and credit-related brokering and intermediaries hold an Australian Credit Licence.

17. The Explanatory Memorandum for the *National Consumer Credit Protection Bill 2009* notes that the need for a separate licencing regime for consumer credit was merited because "credit involves consumers receiving money that they must repay, rather than the purchase of, or investment in, a financial product that generally includes the expectation of a benefit or return from the payment."[14]

18. The NCCPA provides a number of protections for household consumers. These can be generalised into two broad categories:

    - general conduct obligations of licensees; and
    - responsible lending obligations.

19. General obligations require an Australian Credit Licence holder to:

    - meet a number of ongoing standards of conduct when they engage in credit activities, including to maintain competence, manage conflicts of interest and carry out credit activities efficiently, honestly and fairly; and
    - provide for access to redress for consumers through universal external dispute resolution (EDR) membership for licensees, streamlined court arrangements, and remedies for consumers for licensee misconduct.

[13] ASBFEO, February 2018, Fintech lending to small and medium sized enterprises: Improving transparency and disclosure, available: **http://www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-fintech-report.pdf**.

[14] Commonwealth of Australia, June 2009, *National Consumer Credit Protection Bill 2009* Explanatory Memorandum, available: **https://www.legislation.gov.au/Details/C2009B00148/Explanatory%20Memorandum/Text**.

20. As ADIs provide credit to household consumers, they are required by virtue of the NCCPA, to be a member of an authorised EDR body. SMEs borrowing from ADIs, within relevant monetary thresholds, therefore have access to EDR.[15] Small businesses borrowing from unlicensed credit providers do not.

21. Extending the licensing regime, modified as necessary, to unlicensed lenders would, while providing uniform protections for all SMEs obtaining credit, also introduce additional costs for these lenders arising from the need to obtain and meet ongoing licencing requirements. Such costs would in the medium to long run be expected to be passed through to SME consumers and may impact the willingness of some credit providers to remain in the market for SME credit.

22. In considering an extension of a licensing regime for credit to SMEs it is also important to consider the types of credit that could be brought within the regulatory perimeter. The range of credit facilities extended to SMEs is broad and includes not only loans but also bank guarantees; hedges for foreign currency and interest rates; and credit exposures to merchants who collect payment in advance of the delivery of goods and services to their customers. These and a range of more informal credit relationships which exist between businesses (for example, trade credit) could potentially be captured by an extended regime and it is unclear that there is evidence of information asymmetry or other market failures that would merit all such transactions to be licensed.

23. On the other hand, introducing elements of the licensing regime for unlicensed lenders, while potentially increasing costs, could also provide some efficiencies. The Government has introduced legislation into Parliament to introduce mandatory CCR. While CCR only applies to consumer credit, it is likely to benefit both small businesses and lenders as the personal credit history of small business owners often forms part of a lender's credit risk assessment.

24. Under the *Privacy Act 1988*, lenders who do not hold an Australian Credit Licence are not able to participate in CCR and therefore do not have access to the same level of data about borrowers as licensed lenders.[16] For unlicensed lenders, a licensing regime could provide access to information that could reduce the cost of lending through being able to better assess the credit worthiness of small business owners.[17]

Responsible lending obligations

25. The current regulatory framework distinguishes between consumer credit and credit provided to SMEs, with lenders expected to meet responsible lending obligations (RLOs) when lending to consumers but not in relation to loans to SMEs.

15 FOS and CIO's current monetary limit is $500,000 for small business, with a compensation cap of $309,000. Once AFCA commences operations, the monetary limit will increase to $1 million with a compensation cap of $500,000.

16 This may further exacerbate adverse selection risk – SMEs with lower risk profiles in such a market may be able to obtain credit from ADIs while higher risk consumers may not as the ADI is able to more accurately assess their risk. This could result in concentration of higher risk borrowing in unlicensed credit providers.

17 Access to CCR would not necessitate that responsible lending obligations apply for SME lending.

26. RLOs address issues that arise from consumers with relatively low levels of financial literacy engaging with complex credit products and prevent the lender from extending credit to consumers that it reasonably assesses as being unsuitable. Licensees are therefore required to make inquiries and verify the consumer's requirements, objectives and financial situation prior to extending credit. Consumers remain responsible for bearing the risks associated with their decisions, including from adverse changes in their circumstances or conditions within the market that effect loan serviceability.

27. Some small businesses have similarities with consumers in regards to their level of financial literacy and understanding of credit contracts. This is particularly the case for inexperienced small businesses owners who lack historical trading and financial information and expertise in credit contract negotiations. The 2016 Australian Small Business and Family Enterprise Ombudsman *Inquiry into Small Business Loans* identified information overload and the use of complex and technical language in credit contacts as justifications for the use of simpler contracts. The Inquiry observed that small businesses are generally time poor, and usually have to rely on third parties for financial and legal advice, where they can afford such advice.

28. The income and expenses for household consumers are likely to be more straightforward and stable than revenue and expenses for a small business. Revenue and expenses for SMEs are dependent on a number of factors including business decisions and external conditions impacting profitability. Assessing a small business's capacity to service a loan is therefore inherently more uncertain (and, by consequence, riskier).

29. The generally higher risk profile for SMEs is widely recognised and is not merely a feature of the Australian market. The global framework for assessing credit risk as established by the Basel Committee for Banking Supervision requires a higher risk rating for loans to SMEs than, for example, residential real estate.

30. Extending RLOs to credit provided to SMEs, in light of the inherent riskiness, has the potential to increase costs for lenders, which in turn has the potential to increase the cost of borrowing for these businesses.[18] This concern was highlighted by SMEs during Treasury's 2012 consultations to extend the NCCPA to cover small business lending, with small business organisations and the financing and leasing sectors highlighting the likelihood of increased lender costs resulting from the implementation of required new processes and compliance activity.

31. Increased regulation could also reduce the ability of lenders to flexibly meet the diverse needs of small business. The Khoury Review heard evidence that banks need to provide their small business customers with some flexibility in the way in which they conduct credit assessments as part of facilitating commerce. The Review concluded that extending the NCCPA provisions to small business credit would restrict flexibility in an undesirable manner.[19]

18 The likelihood of pass through is higher in a market where price competition is weak, see Productivity Commission, January 2018, *Competition in the Australian Financial System – Draft Report*, available: **https://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf**.

19 Khoury, January 2017, *Report of the Independent Review of the Code of Banking Practice*, p50, available: **http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/02/Report-of-the-Independent-Review-of-the-Code-of-Banking-Practice-2017.pdf**.

32. In addition to flexibility, accessibility of finance remains an important consideration. While around 90% of SMEs which applied for debt finance were successful,[20] access to finance can be a problem for some types of business, such as start-ups, rapidly expanding businesses and businesses where the owner does not have access to collateral, such as real property. The strong preference for offering lending secured by residential real estate is a particular problem for younger business owners. In addition, the price of finance is high (even more so if the lending is unsecured), reflecting a change in risk appetites of lenders following the Global Financial Crisis and, in part, less competition than in other segments of the lending market.

33. For these reasons, in assessing whether regulatory intervention is necessary, consideration of access and cost of credit needs to be balanced against ensuring SMEs receive appropriate outcomes. By its very nature, a SME would generally have less bargaining power than the lender. This inequality may be further exacerbated by factors occurring within the lending environment and during the course of credit discussions and transactions.

34. Extending RLOs to SME lending could help to reduce the risk that these factors could lead to SMEs entering into credit contracts which are unsuitable. Alternatively, enforcement of unfair contract term provisions and the reforms proposed in the Code of Banking Practice could more effectively and efficiently address the issue of complexity for SMEs. Development of a regulatory framework remains a question of balance and using the most efficient tool having regard to all costs and benefits.

Regulatory arbitrage and protections for SMEs

35. As noted above, the majority of the credit provided to SMEs is through the four major banks who subscribe to the Code of Banking Practice (the Code). The Code requires the banks that are subscribers 'exercise the care and skill of a diligent and prudent banker'.[21] While not a legislative requirement, this obligation, as noted by the Commission, places a higher obligation on banks than that which applies to non-subscriber lenders. Additionally, as previously noted, SMEs that obtain credit through banks (and other licensed credit providers) are able to access EDR.[22]

36. Adding further regulatory obligations on ADIs, without extending such obligations to other providers of SME credit, may result in an increase in SMEs seeking credit from unlicensed providers, due to a reduction in the willingness of ADIs to engage in the SME credit market or higher costs. Unlicensed credit providers offer fewer protections for SMEs thereby exacerbating risks for SMEs.

20 In 2015-16. ABS 8167.0 – Selected Characteristics of Australian Businesses, 2015-16 (Data Cube – Business Finance, Table 1).

21 Australian Bankers' Association, 2013, Code of Banking Practice, available: **http://www.ccmc.org.au/cms/wp-content/uploads/2014/09/2013-Code-of-Banking-Practice-and-CCMC-Mandate.pdf**.

22 Data from the Financial Ombudsman's Service (FOS) suggests that most disputes in relation to small business loans are resolved by the financial services provider and relate to financial difficulty requests and other requests for assistance.

USE OF NON-MONETARY DEFAULT CLAUSES

37. Non-monetary default clauses have historically been used in Australia and comparable jurisdictions to manage credit risks that may arise during the term of the loan, which, as noted earlier, are higher for small business than in other types of lending.

38. The Commission heard evidence about the adverse impact of non-monetary default clauses, coupled with lack of transparency and communication by the lender, can have on individual borrowers. It also heard evidence about recent changes to the use of these clauses in small business loan contracts as a result of ASIC's work with the major banks on compliance with unfair contract terms legislation (for contracts of less than $1 million) and through the introduction of 'covenant light' small business loan contracts in the draft banking code, which would apply to borrowers who meet a (debated) definition of 'small business'.

39. The existence of non-monetary default clauses alters the balance between lender and borrower. For this reason, it is important that there are appropriate checks and balances to the use of such provisions to ensure that the clauses are genuinely needed to protect the lender's interests. Such checks and balances include constraints around their use, considering the materiality of breach, providing opportunities for the borrower to remedy a breach, transparency and timely access to redress in the event of a dispute. This is consistent with the approach outlined in ASIC's Report on Unfair Contract Terms,[23] and featured in the draft banking code, for eligible businesses and contracts.[24] On access to redress, the Australian Financial Complaints Authority's (AFCA's) Rules (previously known as terms of reference) explicitly includes disputes about non-monetary defaults of a credit facility as being within AFCA's jurisdiction.

40. Nevertheless, non-monetary default clauses can have a legitimate role in managing risk. They can also serve as an early sign that a borrower is experiencing difficulties, indicating that discussion with the borrower is needed on business prospects and outlook. At the margin, the availability of such clauses could have an impact on the lender's decision on whether to grant credit or on what terms, including loan pricing or loan tenors. Complete removal of these risk management tools may result in behavioural responses from lenders like higher pricing, reduced loan tenors or higher collateral requirements. Such changes, particularly reduced loan tenors, could introduce a new source of uncertainty for borrowers.

23 Australian Securities and Investments Commission, 2018, *Report 565 'Unfair contract terms and small business loans*, available: **https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-565-unfair-contract-terms-and-small-business-loans/**.

24 Australian Banking Association, Draft Banking Code, available: **https://www.ausbanking.org.au/images/uploads/New_Draft_Code.pdf**.

INDUSTRY CODES

41. Industry codes have an important role in lifting standards above that required by the law. However, this role is not comprehensive. The 2017 ASIC Enforcement Review Taskforce noted that: "One of the major challenges of the current industry code of conduct regime is that the benefits of industry codes are not available to significant numbers of consumers because not all players in relevant industry subsectors are code subscribers." [25]

42. The majority of business lending is undertaken by the major banks, who are signatories to the Code of Banking Practice, and the Australian Banking Association (ABA) has indicated that subscribing to the new Code will become a condition of ABA membership.[26] The CEO of the ABA also noted in evidence that the Code may have an effect on non-subscribers by becoming the benchmark by which a lender is assessed if a dispute arises.[27]

43. Despite this, gaps and inconsistencies will remain, as multiple codes (current and foreshadowed) operate across the SME lending sphere and, in some areas of SME lending, there is no code in place.[28] As a result, there is a risk that extensive protections for borrowers, at the expense of access and cost, in one particular code, may result in borrowers going elsewhere to lenders who are not constrained in the same way.

44. This drawback of self-regulation could be used as an argument for standards to be set in legislation which covers all lenders. An alternative approach would be to reform the framework for industry codes to deliver higher quality outcomes, with a more powerful role for ASIC in promoting higher standards, greater coverage and enforceability. To that end, the 2017 ASIC Enforcement Review Taskforce has recommended:

    - that ASIC approval should be required for the content of and governance arrangements for relevant codes (Recommendation 18);
    - entities should be required to subscribe to the approved codes relevant to the activities in which they are engaged (Recommendation 19);
    - approved codes should be binding on and enforceable against subscribers by contractual arrangements with a code monitoring body (Recommendation 20);
    - an individual customer should be able to seek appropriate redress through the subscriber's internal and external dispute resolution arrangements for non-compliance with an applicable approved code (Recommendation 21); and

25 Australian Government, 2017, *ASIC Enforcement Review Taskforce Final Report*, p.34

26 Royal Commission transcript, 31 May page 2922, lines 5-6

27 Royal Commission transcript, 31 May page 2921, lines 30-38

28 For example, the current Customer Owned Banking Code covers customer owned banks, while a FinTech Lenders Code is currently under development, see FinTech Australia media release '*Fintech business lenders move to increase transparency*', 27 February 2018.

- the code monitoring body, comprising a mix of industry, consumer and expert members, should be required to monitor the adequacy of the code and industry compliance with it over time, and periodically report to ASIC on these matters (Recommendation 22).

45. It should be noted that this model would operate only in sectors where ASIC considered its application appropriate having regard to all the circumstances.

46. The Government has provided in-principle agreement for these recommendations, noting that the Royal Commission will consider the adequacy of forms of industry self-regulation, including industry codes of conduct. The Government also indicated that it would defer implementation of these recommendations to enable it to take account any findings arising out of the Royal Commission.[29]

47. The detailed design and application of these recommendations require further development, including how any requirement would be put in place (such as a licence or other means); defining the type of products and entities that should be covered; and the potential for multiple codes to apply.

29 Australian Government, 2018, *Response to the ASIC Enforcement Review Taskforce Report*, available: **https://static.treasury.gov.au/uploads/sites/1/2018/04/Aus-Gov-response-ASIC-Enforcement-Review-Taskforce-Report.docx**.