Australian Government

The Treasury

FINANCIAL SERVICES ROYAL COMMISSION

REQUEST FOR INFORMATION

REFORMS TO SMALL BUSINESS LENDING

This paper was prepared by Treasury in response to a request made by the Royal Commission

OVERVIEW OF REFORMS TO SMALL BUSINESS LENDING

Small and medium enterprises (SMEs) make up a significant part of the Australian economy. Australia has more than two million small and medium enterprises, accounting for more than 65 per cent of private sector employment.[1] The aggregate value of bank lending to small business (defined as loans of less than $2 million) accounts for around 28 per cent of total bank lending to business.[2]

At the request of the Royal Commission, this information note identifies reforms affecting SME lending introduced since 2007. There is, however, no common definition of a small or a medium enterprise used in Australia.[3] The reforms outlined in this information note primarily concern reforms that are of relevance to small businesses rather than medium sized enterprises which are treated consistently with larger enterprises within the regulatory framework.

External finance plays an important role in providing small businesses with the funds they need to grow and create jobs. A significant focus of reform efforts in relation to small business finance has been on improving access to finance for these businesses. The issue of access to finance for SMEs was identified as one of the four main concerns in relation to the flow of funding in the Australian economy by the Financial System Inquiry (FSI) in 2014.[4]

The cost of finance is a significant issue, with small business loan interest rate spreads widening markedly during the Global Financial Crisis and remaining elevated since then.[5] In part this can be explained by changes in risk appetites by lenders and their assessment of the riskiness of small business loans, but it is also a consequence of a less competitive market than that for large businesses (who can access credit from foreign banks and capital markets).

Obtaining credit can also be an issue for certain types of small businesses. While 90 per cent of credit applications by small businesses are approved, the major part of this credit is secured by property. Unsecured credit is harder to obtain. This places start-ups and rapidly expanding businesses at a disadvantage, particularly those with younger owners who are less likely to have existing assets, such as a home, to provide as collateral. Unsecured lending also comes at a significantly higher price.

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1 ASBFEO, 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

2 Reserve Bank of Australia, December Quarter 2017, *Money and Credit Statistics*, Bank Lending to Business – Total Outstanding by Size and Sector.

3 Small businesses are defined by the Australian Taxation Office as being a business with an aggregate turnover of less than $10 million; by the Australian Bureau of Statistics (ABS) as being a business with less than 20 employees; and by the *Fair Work Act* as being a business with less than 15 employees. The Australian Securities and Investments Commission (ASIC) notes these differences in definitions, adopting the ABS definition for its purposes.

4 Financial System Inquiry, November 2014, *Final Report*, p.14, available: http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

5 Reserve Bank of Australia, December 2017, *The Availability of Business Finance*, available: https://www.rba.gov.au/publications/bulletin/2017/dec/pdf/bu-1217-7-the-availability-of-business-finance.pdf

In general, the FSI and consequent reforms have sought to address these issues by strengthening competition, most notably improving the availability of data for lenders on small businesses by mandating comprehensive credit reporting 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. Government has also taken measures to improve access to equity finance for small businesses, including the introduction of a crowd-sourced equity funding framework and tax incentives to invest in early stage companies and eligible venture capital funds.

The issue of access and pricing of finance for SMEs is also currently subject to consideration 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.[6]

At the same time, it has also been recognised that, as for non-business consumers, small businesses can lack the time or ability to engage effectively with financial institutions and products and make fully-informed decisions. The regulatory framework for small business has historically lacked the consumer protections that are in place for household consumer credit. While small businesses now benefit from fairness of contract terms, general legal protections against misleading, deceptive and unconscionable conduct, and, when engaging with regulated consumer credit providers, access to external dispute resolution arrangements, more specific protections around responsible lending obligations and disclosure requirements and dispute resolution do not apply.

A subset of recent reforms has therefore sought to increase such specific protections for small businesses — where the benefits of doing so have been seen as exceeding the potential downsides of reduced access and higher cost of credit. Those downsides can arise through various channels, for example: increased regulation overall can discourage new small business lenders entering the market, increase the cost of processing loan applications, and increase credit risk if risk controls are weakened or collateral becomes more difficult to enforce.

This paper outlines in turn:

- reforms to improve protections for small business consumers;
- reforms to improve access to finance for small business consumers; and
- other reforms affecting small business access to finance.

Additionally, and also at the request of the Royal Commission, an overview of recent reforms to the regulation of registered liquidators is included in Attachment A. While not directly related to SME lending, these reforms have relevance for SMEs that encounter difficulties in meeting their repayment obligations and are subject to insolvency or liquidation processes.

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6 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

Measures to improve protections in small business lending

Protections for SMEs in the current regulatory framework for consumer credit

The *Australian Securities and Investments Commission Act 2001* (ASIC Act) prohibits certain conduct in relation to the provision of a financial service (as defined in the ASIC Act).[7] These include prohibitions on:

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

In addition to these general prohibitions on conduct, SMEs engaging with financial institutions that hold an Australian Credit Licence under the *National Consumer Credit Protection Act 2009* (NCCP Act) benefit from access to External Dispute Resolution (EDR) arrangements (subject to jurisdiction restrictions of EDR schemes as discussed below). The RBA estimates that approximately 80 per cent of lending to small businesses is provided by the major authorised deposit-taking institutions (ADIs) who also hold a credit licence.[10]

A financial services entity is only required to hold an Australian Credit Licence if it engages in certain credit activities.[11] Broadly a licence is only required where the credit contract is wholly or predominantly for personal, domestic or household purposes, or for investment in residential property. Where a financial services institution provides credit only for business purposes, then they need not hold an Australian Credit Licence and hence the requirement to be a member of an approved EDR scheme does not apply.

The NCCP Act also requires credit licensees, amongst other obligations, to lend responsibly to household consumers. These obligations do not apply when lending to small business consumers.

The responsible lending obligations (RLOs) require a credit licensee to:

- make reasonable inquiries about a consumer's financial situation, and their requirements and objectives;
- take reasonable steps to verify their financial situation; and

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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*. *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 AISC Act.

10 Reserve Bank of Australia, December 2017, The Availability of Business Finance, available: https://www.rba.gov.au/publications/bulletin/2017/dec/pdf/bu-1217-7-the-availability-of-business-finance.pdf

11 That is credit activity in relation to a credit contract or consumer lease to which the National Consumer Credit Code applies.

- make a final assessment about whether the credit contract is ‘not unsuitable’ for the consumer based on the inquiries and information obtained by the credit provider.

When the Council of Australian Governments (COAG) agreed in 2008 to the introduction of a national regime for the regulation of consumer lending in Australia it was also agreed that there would be a second phase to the NCCP Act reforms, which was intended to include extending similar protections to cover small businesses.

Schedule 2 of the *National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012,* released for public consultation in December 2012, included provisions to:

- introduce a permit system for providers of small business credit who are not required to hold a credit licence, including brokers and intermediaries;
- apply modified RLOs to small business credit contracts;
- require providers of credit assistance, such as brokers and advisors, to provide small businesses with information (quotes) about credit assistance; and
- require credit providers (lenders) to provide small business customers with a disclosure document outlining matters such as the amount of credit, rates and repayments.

While consumer advocacy bodies generally supported the proposals, small business organisations and the financing and leasing sectors raised concerns with the draft legislation including that:

- the regime would result in unnecessary duplication and compliance costs;
- the measures would likely restrict lending to small businesses and make the lending process more difficult and expensive for lenders;
- small businesses would need to spend more time and resources in order to access finance; and
- the measures would not deter unfair credit practices.

In light of the consultation feedback, in February 2013, the then government announced that it would defer the small business credit reform proposals to allow for consideration of whether similar benefits could be delivered in a more effective and targeted way.

These specific reforms have not been revisited subsequently, and in effect other more targeted reforms, such as the extension of unfair contract term protections and reforms to non-monetary covenants outlined below, have been pursued instead.

Unfair contract terms

Introduction of the Australian Consumer Law (ACL) and reforms to the ASIC Act in 2010 introduced protections for consumers against unfair contract terms in standard form contracts, including credit products.

These changes formed part of the recommendations of the Productivity Commission’s 2008 *Review of Australia’s Consumer Policy Framework*, which recommended incorporating a provision in the new

consumer law that addresses unfair contract terms. Similar provisions had already been in force in Victoria and jurisdictions outside of Australia.

In 2013, the then Government announced that unfair contract term protections would be extended to small business contracts recognising that like individual consumers, small businesses can lack the time and legal or technical expertise to understand or critically analyse contracts and the bargaining power to negotiate terms specified in contracts. Compared to larger businesses, small businesses were seen as often having a more limited capacity to manage certain risks.

The FSI supported the extension of unfair contract term protections to small businesses and encouraged industry to develop standards on the use of non-monetary default covenants (discussed below).

The *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015* legislated to:

- extend the consumer unfair contract term protections in the ASIC Act and the ACL to small business contracts that meet the prescribed criteria (as outlined below); and

- make provision for exempting certain small business contracts from the operation of the legislation, where those contracts are subject to prescribed laws that are deemed equivalent to the unfair contract term protections in the ASIC Act or the ACL, and which are enforceable.

The unfair contract term protections allow a court to declare a term of a standard form contract to be unfair and hence void.

Contracts covered include those between businesses where one of the businesses employs fewer than 20 people and the contract is worth up to $300,000 in a single year or $1 million if the contract runs for more than 12 months.

Whether a contract is a standard form contract is dependent, broadly, on the relative bargaining power of each of the parties, and related issues.[12]

To date, the exemption mechanism that allows certain contracts to be excluded from protections where there is an equivalent and enforceable protection under the law has not been used.

The law applies to standard form small business contracts entered into or renewed on or after 12 November 2016. If a contract was varied on or after 12 November 2016, the law applies to the varied terms.

A statutory review of the extension of unfair contract term provisions to small business contracts will occur in late 2018.

REFORMS TO NON-MONETARY COVENANTS

Following the commencement of the unfair contract term reforms (noted above), ASIC and ASBFEO conducted a review of small business loan contracts of up to $1 million offered by the four major banks.

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12 Matters a court must take into account in determining whether a contract is a standard form contract are specified in subsection 12BK(2) of the ASIC Act.

The review reflected concerns that those banks had not brought their small business loan contracts into compliance with the law.

The review identified a number of terms in small business credit contracts that could potentially be unfair, including non-monetary covenants that give lenders a broad discretion to call a default and impose default-based consequences even when the borrower has met their regular repayments.

On 24 August 2017, the four major banks agreed to make a number of changes to their small business loan contracts to eliminate unfair contract terms for loan contracts of up to $1 million, including:

- removing 'entire agreement' clauses that absolve the lender from responsibility for conduct, statements or representations they make to borrowers outside the written contract;
- significantly limiting the operation of broad indemnification clauses, so that small business borrowers will not be required to reimburse the lender for losses, costs, expenses and liabilities incurred by the lender arising from the fraud, negligence or wilful misconduct of the bank, its employees or a receiver appointed by the bank;
- limiting the banks' ability to vary contracts unilaterally to specific circumstances, and where such a variation would cause a customer to want to exit the contract, providing a period of between 30 and 90 calendar days for them to do so; and
- addressing the use of non-monetary defaults, including removing material adverse change clauses that allow banks to terminate a loan for an unspecified negative change in the borrower's circumstances.

In making the announcement, the ASBFEO noted that the four major banks had agreed to extend unfair contract term protections from the $1 million contract mandated by the law, to $3 million.[13]

The changes to small business loan contacts by the four major banks to comply with the unfair contract terms law are outlined in ASIC Report 565 *Unfair contract terms and small business loans*.[14]

Revised Code of Banking Practice

The Code of Banking Practice (the Code) is a voluntary code of conduct developed by the Australian Banking Association (ABA) that first took effect in 1996. It covers individuals or small businesses that are an actual or prospective customer involved in retail banking transactions. Approximately 14 of the ABA's 24 members are signatories to the most recent in force version of the Code.[15]

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13 ASBFEO and ASIC, 24 August 2017, Media release *Big four banks change loan contracts to eliminate unfair terms*, available: http://asbfeo.gov.au/news/news-articles/big-four-banks-change-loan-contracts-eliminate-unfair-terms-small-business

14 ASIC, 2018, REP 565 *Unfair contract terms and small business loans*, available: http://download.asic.gov.au/media/4676255/rep565-published-15-march-2018.pdf

15 ABA, *Banks that have adopted versions of the Code of Banking Practice*, available: https://www.ausbanking.org.au/Industry-Standards/ABAs-Code-of-Banking-Practice/Banks-that-have-adopted-versions-of-the-Code-of-Banking-Practice, accessed 30 April 2018; ABA, 'Members', available https://www.ausbanking.org.au/about-us/members/, accessed 30 April 2018

In December 2017, the ABA provided a revised Code to ASIC for approval under the *Corporations Act 2001*. ASIC is currently considering the ABA's application.

The revised Code includes a dedicated section on small business and a number of changes in relation to small business lending to implement public commitments made by the ABA in response to relevant reviews, including:

- the Independent Review of the Code of Banking Practice (Khoury Report); [16] and
- ASBFEO's *Inquiry into Small Business Loans* (the Carnell Inquiry).[17]

In its public statements on the revised Code, the ABA has stated that small businesses, for the purposes of concessions in the Code, are defined as having fewer than 20 full-time equivalent employees (or 100 employees for manufacturers), annual business turnover of less than $10 million, and total credit exposure of the business group of less than $3 million.[18] This definition varies from that recommended by the Khoury Report and the Carnell Inquiry, which recommended that the Code provisions that relate to credit apply to loans of up to $5 million.

Other announced key changes for eligible small businesses in the Code are:

- simplified, improved disclosure of loan terms and conditions and loan approval processes and outcomes for small businesses;
- increased notice periods for small businesses for enforcement proceedings and decisions on rollover;
- the introduction of 'covenant light' contracts to eligible loan products, which reduce the number of specific events of non-monetary defaults and remove financial indicator covenants as triggers for default; and
- improved requirements to provide to small businesses adequate arrangements to address conflict of interest issues between investigating accountants and receivers, and provision of information about entitlements to access dispute resolution.

The ABA has also developed Industry Guidelines that include topics including appointing a valuer or appointing a receiver/administrator. The guidelines are not part of the Code and are therefore voluntary.

Currently, subscription to codes is voluntary for industry participants, as is submission of a code to ASIC for its approval. The ASIC Enforcement Review Taskforce, in its December 2017 report, made a series of recommendations on codes. These included that participants in certain sectors (to be determined by ASIC) of the financial services industry should be required to subscribe to industry codes that are approved by

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16 Khoury, P, 2017, *Independent Review of the Code of Banking Practice*, 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

17 ASBFEO, 2017, *Inquiry into Small Business Loans*, available: http://www.asbfeo.gov.au/sites/default/files/030217-ASBFEO_Report.pdf

18 Australian Bankers' Association, 28 April 2017, Media Release *ABA responds to Carnell inquiry recommendations*, available: https://www.ausbanking.org.au/media/media-releases/media-release-2017/aba-responds-to-carnell-inquiry-recommendations

ASIC. The Taskforce also recommended that in order to obtain ASIC approval, codes be required to include certain minimum standards on enforceability, including that subscribers be contractually bound to a code monitoring body. The Government has agreed-in-principle to these recommendations but deferred implementation to enable it to take account of any findings in relation to codes by the Royal Commission.[19]

Report on FinTech lending to SMEs

FinTech providers, such as marketplace lenders, are an emerging alternative financing option for small and medium businesses.

Recognising that a lack of transparency and disclosure can make it difficult for SMEs to compare products offered by different FinTechs, or products offered by FinTechs and authorised-deposit taking institutions (ADIs), on 28 February 2018, the ASBFEO, Fintech Australia (the peak national organisation for Australia's financial technology sector) and theBankDoctor.org (online service offering free banking and finance advice to small business owners) released the report *FinTech lending to small and medium-sized enterprises: Improving transparency and disclosure*.[20]

The report included commitments to improve transparency and disclosure by FinTech lenders, including development by June 2018 of an industry code of conduct, an easy to understand contract summary page and a guide to assist SMEs better understand the process of borrowing from a FinTech lender.

Australian Financial Complaints Authority

On 20 April 2016, the Australian Government commissioned a review into the financial system external dispute resolution (EDR) and complaints framework, to be led by a panel of experts — Professor Ian Ramsay (Chair), Julie Abramson and Alan Kirkland. The review was announced as part of a broader package of reforms to improve consumer protections.

The Panel made 11 recommendations representing an integrated package of reforms to improve the Australian EDR framework's capacity to address current problems and ensure its design would withstand the challenges of a rapidly changing financial system.

The key recommendation was the creation of a single dispute resolution body to streamline the handling of complaints in the financial system and address duplication and consumer confusion in the existing framework. In making that recommendation, the Ramsay Review also had regard to recommendations made by the Carnell Inquiry to increase the monetary value of complaints that could be brought to EDR schemes, and increase the amount of compensation that could be awarded.

The Australian Financial Complaints Authority (AFCA) is part of the Government's work to improve the dispute resolution framework that exists for consumers with financial complaints, including small businesses. AFCA is replacing the existing EDR schemes (the Financial Ombudsman Service, the Credit and

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19 Commonwealth of Australia, 16 April 2018, *Australian Government response to the ASIC Enforcement Review Taskforce Report*, available: https://treasury.gov.au/publication/p2018-282438/

20 ASBFEO, FinTech Australia and theBankDoctor.org, 2018, *Fintech lending to small and medium-sized enterprises: Improving transparency and disclosure*, available: http://asbfeo.gov.au/sites/default/files/documents/ASBFEO-fintech-report.pdf

Investments Ombudsman and the Superannuation Complaints Tribunal), and will begin to accept complaints from 1 November 2018.

Information on AFCA's small business jurisdiction is provided below. Information on AFCA's establishment more generally is at Attachment C.

AFCA'S SMALL BUSINESS JURISDICTION

AFCA will be able to hear complaints from small businesses in relation to credit facilities up to a limit of $5 million (compared to the previous limit of $2 million), and be able to award compensation of up to $1 million (compared to the current cap of $323,500).[21] For small businesses that are primary producers (consistent with the definition in the *Income Tax Assessment Act 1997*), the limit on the size of disputes relating to credit facilities remains at $5 million, but the compensation available will increase to $2 million (up from $323,500).[22]

AFCA's jurisdiction will allow complaints relating to non-monetary covenants (where they fall within the above monetary limits) to be heard. Further, AFCA will operate with an expanded definition of small business, so that businesses with less than 100 employees will be able to bring their complaints to AFCA.

Australian Small Business and Family Enterprise Ombudsman

The Australian Government established ASBFEO in March 2016, in response to concerns that small businesses were not being well-served by Commonwealth policy and legislation.

ASBFEO has the role of supporting small business by:

- advocating for small businesses and family enterprises;
- contributing to the development of small business related policy and legislation; and
- providing assistance to small businesses in accessing dispute resolution services.

ASBFEO has conducted or commenced several inquiries and research papers relating to small business lending and access to finance, including the FinTech lending report outlined above (February 2018), Barriers to Investment (November 2017), Payments Times and Practices Inquiry (April 2017), Small Business Loans Inquiry (February 2017), and the recently announced Affordable Capital for SME Growth Inquiry, which will examine initiatives to provide affordable capital to SMEs.

ASBFEO's dispute assistance function seeks to improve the capacity of small businesses to resolve disputes with their financial service providers. This function can entail advice, counselling, pre-mediation, or referral by ASBFEO to an alternative dispute resolution provider where that provider has the power to deal with the request, such as the Financial Ombudsman Service or, in the near future, AFCA.

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21 FOS and CIO compensation caps at 1 January 2018

22 Ibid

Measures to improve small business access to finance

As noted earlier in this information note, a number of reforms to the regulatory frameworks relate to improving access and pricing of credit for small businesses.

The FSI identified increased access to and use of data in particular as an important driver to increasing access and improving the price of credit for small businesses. The FSI found that increased data availability and use had the potential to foster competition and the introduction of new and innovative products.[23] Following the FSI, reforms have focused on improving competition through increasing the availability and access to data and innovation in data use; these reforms are noted below.

Comprehensive credit reporting

The Government announced in the 2017-18 Budget that it would legislate to make participation in comprehensive credit reporting (CCR) compulsory if 40 per cent of credit accounts were not being reported by the end of 2017. This followed recommendations from the 2014 *Financial System Inquiry* and the Productivity Commission's (the PC) *Inquiry into Data Availability and Use*.

On 2 November 2017, the Government further announced that it would legislate to require the four major banks to share comprehensive credit information with credit reporting bodies by 1 July 2018. The Government has introduced the *National Consumer Credit Protection (Mandatory Comprehensive Credit Reporting) Bill 2018* into Parliament. The Bill will require Australia's four largest banks to share comprehensive credit information on consumer credit accounts with credit reporting bureaus.

The purpose of these reforms is to improve how lenders meet their RLOs and give lenders access to data that will encourage competition for small business and retail customers with positive credit histories. While CCR only applies to consumer credit, it is likely to benefit small businesses as the personal credit history of their owners often forms part of a lender's credit risk assessment.

Open banking

In 2017, the Australian Government commissioned the *Review into open banking in Australia* to examine how an open banking regime could boost innovation and competition in the financial sector, and make recommendations on how best to implement such a regime.

Open banking is intended to give customers greater access to, and control over, their own banking data. It will give customers the right to direct that their data be shared with trusted third parties in a machine readable form, enabling customers more easily to identify and switch to banking products that best suit their needs. In doing so, open banking is intended to facilitate and encourage the financial sector to provide a wider range of more competitively priced products to both consumers and businesses.

Other countries, including the United Kingdom, are also pursuing initiatives to increase customers' access to data in financial services.

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23 The FSI provides examples of how increased data access and usage can enhance access to finance for small businesses. Refer to cameo on potential benefits of enhanced data usage – p.183

Open banking is the first implementation of the Consumer Data Right that will apply more broadly across the economy, following the recommendations of the FSI and the PC's *Inquiry into Data Availability and Use*.

The Government is currently considering the outcomes of its recent consultation on the Review's recommendations.

Other reforms relating to small business access to finance

Australian Prudential Regulation Authority's review of the capital adequacy framework

The Australian Prudential Regulation Authority (APRA) is responsible for setting prudential standards for the amount of capital that ADIs must hold against the risks in their business. This is known as the 'capital adequacy framework'.[24] Capital adequacy is determined by a ratio of capital held against risk-weighted assets – the 'capital adequacy ratio'. The most significant risk for ADIs is the risk that borrowers will not repay the money that is owed, which is known as credit risk.

APRA's capital adequacy framework takes into account the risks associated with different types of loans. Consistent with the internationally agreed framework developed by the Basel Committee on Banking Supervision (BCBS), Australia's capital framework allows two approaches to determining capital requirements for loans, including loans to SMEs:

- The standardised approach is the default approach and uses an APRA-determined set of risk weights to reflect general risks of different asset classes. This approach is used by most ADIs.
- The internal ratings-based (IRB) approach which permits, subject to APRA approval, an ADI to use its own internal financial models and experience data to assess risk at a more granular level, and set capital parameters accordingly. This approach is only used by larger and more sophisticated ADIs.

APRA released a discussion paper on 14 February 2018 which proposes changes to the capital adequacy framework. This follows the finalisation of Basel III, the international standard set by the BCBS, in December 2017. APRA's proposals reflect the changes set out in Basel III as well as further measures aimed at better aligning capital requirements with underlying risks. The proposed changes include changes to capital requirements for SME lending.

In finalising the revised capital adequacy framework for ADIs, APRA has stated that it will consider the findings of the PC inquiry into competition in the Australian financial system.[25]

It is worth noting that changes to the consumer protection provisions governing access to credit to SMEs may have an impact on ADI's capital requirements. For example, any additional constraints on an ADI's capacity to realise collateral held against SME exposures could impact the amount of regulatory capital required, which may have pricing implications.

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24 Further information on the capital adequacy framework is available in the background paper APRA prepared for the Commission: APRA, April 2018, *Background Paper: The regulatory capital framework for authorised deposit-taking institutions (ADIs)*, available: https://financialservices.royalcommission.gov.au/publications/Pages/default.aspx

25 The draft report found that ADIs using the standardised approach held significantly more capital against SME loans which were not secured by a residence than ADIs using the IRB approach and recommended that APRA provide a broader schedule of risk weights rather than applying a single risk weight to all SME loans not secured by a residence under the standardised approach to credit risk.

Measures related to equity finance

Equity finance is also an important source of funds for small businesses, particularly those that are at an early stage of development or are developing innovative goods or services and for whom debt finance may not be suitable or available.

The Government has implemented several policies designed to improve access to equity finance for early stage businesses, including:

- a crowd-sourced equity funding framework (CSEF) that makes it easier for eligible companies with up to $25 million in gross assets and annual turnover to raise equity from the public;[26]
- a tax incentive for early stage investors, which provides concessional tax treatment for eligible investments in innovative, high-growth potential start-ups; and
- Early Stage Venture Capital Limited Partnerships (ESVCLP) and Venture Capital Limited Partnership (VCLP) programs, which provide concessional tax treatment to eligible classes of investors in each respective eligible venture capital fund.

26 CSEF is currently available for unlisted public companies. Legislation is currently before the Parliament to extend the framework to proprietary companies.

ATTACHMENT A – INSOLVENCY REFORMS

Banks remain the principal source of credit for SMEs. Banks normally lend to SMEs on a secured basis, for example a mortgage, and have the ability to appoint a receiver over the secured assets when the SME is under significant financial distress or is insolvent. The receiver then takes control of and sells some or all of the company's assets to repay the bank. Receivers have a statutory duty to take reasonable care to sell collateral for not less than its market value or, if there is no market value, the best price reasonably obtainable.

The conduct of receivers appointed to SMEs has been raised during numerous inquiries over the last decade.[27] A receiver must be a registered liquidator, and over recent years the Government has significantly reformed the regulation and discipline of registered liquidators. The *Insolvency Law Reform Act 2016*, which fully commenced on 1 September 2017, strengthens Australia's insolvency regime by: [28]

a. improving practitioner discipline, insurance requirements and registration processes;

b. providing new regulatory powers to ASIC;

c. enhancing the ability of creditors to terminate underperforming practitioners;

d. introducing new review and audit processes;

e. addressing conflicted remuneration; and

f. ensuring that offences and penalties are appropriate and proportionate.

In 2017, Parliament also enacted the *Treasury Laws Amendments (2017 Enterprise Incentives No.2) 2017 Act* (Enterprise Incentives Act) which was aimed at promoting a culture of entrepreneurship and innovation and providing breathing space for distressed businesses to restructure.

The threat that Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent, had long been criticised as driving directors to enter formal insolvency even in circumstances where the company might have been viable in the longer term.

The Enterprise Incentives Act:

- created a safe harbour for company directors from personal liability for insolvent trading if the company is undertaking a restructure outside formal insolvency; and
- from 1 July 2018, introduces a stay on the operation of ipso facto clauses which automatically terminate or amend a contract when a company has entered into a formal insolvency regardless of the company's continued performance of its obligations under the contract.

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27 These include the 2010 Senate Economics References Committee's *Inquiry into the regulation, registration and remuneration of insolvency practitioners in Australia*, the 2012 Senate Standing Committee on Economics *Inquiry into the post-GFC banking sector* and its 2015 *Inquiry into insolvency in the Australian construction industry*, as well as the Carnell Report and the 2017 Senate Select Committee *Lending to Primary Production Customers*.

28 Note: (c), (d) and (e) do not apply to receivers.

The safe harbor encourages directors to engage early with financial difficulty free from personal liability where they are pursuing a course of action reasonably likely to lead to a better outcome than immediate formal insolvency.

The stay on ipso facto clauses promotes business recovery and restructuring by assisting viable but financially distressed companies to continue to operate and salvage the remaining value of the business, increasing the likelihood of selling the business as a going concern.

ATTACHMENT B – AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION SMALL ENTERPRISE LENDING REFORMS SINCE 2007

DATE	TITLE	DESCRIPTION
June 2013	RG 139 Approval and oversight of external dispute resolution schemes.	Provides revised guidance to external dispute resolution (EDR) schemes obtaining ASIC approval to operate, and their ongoing requirements to maintain approval. Includes ASIC's expectations on the small business lending disputes that must be excluded from the terms of reference of EDR schemes. ASIC is currently consulting on an update to RG 139 in light of the creation of the Australian Financial Complaints Authority (CP 298 Oversight of the Australian Financial Complaints Authority: Update to RG 139).
February 2016	INFO 211 Unfair contract term protections for small businesses.	Gives guidance to assist small businesses understand how the law deals with unfair terms in small business contracts for financial products and services, and the protections that are available for small businesses.
February 2016	RG 96 Debt collection guideline: for collectors and creditors.	Provides updated ASIC and ACCC guidelines for debt collectors and creditors who use external collection agencies.
March 2016	INFO 213 Providers of marketplace lending products.	Gives guidance to assist providers of marketplace lending products and others providing financial services in connection with these products.
March 2016	INFO 207 Disputes about commercial loans	Provides guidance on disputes about commercial loans.
March 2018	REP 565 Unfair contract terms and small business loans.	Outlines the changes to small business loan contracts by the four major banks to comply with unfair contract terms law and provides general guidance for other lenders to small business borrowers.

ATTACHMENT C – ESTABLISHMENT OF AUSTRALIAN FINANCIAL COMPLAINTS AUTHORITY

This attachment provides an overview on the establishment and operation of the Australian Financial Conduct Authority (AFCA).

What is AFCA?

AFCA will be a new single external dispute resolution (EDR) body in the financial system for all financial disputes (including for superannuation disputes). It was the key recommendation of the Review of the financial system external dispute resolution (EDR) and complaints framework (Ramsay Review).

The Ramsay Review Panel released an Issues Paper (9 September 2016), Interim Report (6 December 2016) and provided its Final Report to Government on 3 April 2017. The Panel received 127 submissions to its Issues Paper and 56 submissions to its Interim Report. The Panel also held multiple roundtables and individual meetings with stakeholders.

The Panel found that the current framework was a product of history rather than design. The existence of multiple EDR schemes meant it was difficult to achieve comparable outcomes for consumers with similar complaints, contributed to consumer confusion and made it more difficult for consumers to progress disputes involving firms that are members of different EDR schemes. Multiple EDR schemes also resulted in duplicative costs for industry and regulators.

The Panel also found that the dispute resolution arrangements for superannuation suffered from chronic underfunding and a lack of flexibility, at a time when greater proportions of the population would move into retirement and draw down on superannuation accounts.

The Panel made 11 recommendations representing an integrated package of reforms to improve the Australian EDR framework's capacity to address current problems and ensure its design would withstand the challenges of a rapidly changing financial system.

The key recommendation was the creation of a single dispute resolution body to streamline the handling of disputes in the financial system and address duplication and consumer confusion in the existing framework.

The Government announced the creation of AFCA in the 2017-18 Budget, accepting all 11 recommendations of the Ramsay Review and introduced legislation into Parliament in September 2017.

AFCA is established under the *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018 (Cth)*, which was passed by Parliament on 14 February 2018 ('AFCA legislation').

Who will operate AFCA?

The responsible Minister — the Minister for Revenue and Financial Services — is able to authorise a company to operate the AFCA scheme if satisfied it will meet the mandatory requirements specified in the AFCA legislation. The Minister can also have regard to general considerations specified in the legislation.

While the legislation sets out mandatory requirements and general considerations that the scheme must meet, it does not prescribe the way in which AFCA can satisfy those requirements. This provides AFCA with the flexibility to make operational decisions (for example, in relation to the number and type of staff it hires, dispute resolution processes it puts in place, and fees charged to members).

- This flexibility is a key feature of industry ombudsman schemes and stands in contrast to the current dispute resolution arrangements applying to superannuation — the Superannuation Complaints Tribunal (SCT), which is a statutory body.

A key document that will set out the kinds of disputes AFCA will hear and the processes it will use to resolve disputes is the AFCA terms of reference (which sets out jurisdiction, remedies, dispute resolution processes and is a binding contract between the scheme, its members and complainants).

On 1 May 2018, the Minister announced her authorisation of Australian Financial Complaints Limited (AFCL) to operate the AFCA scheme. As part of her authorisation decision, the Minister announced that AFCA would commence accepting disputes from 1 November 2018.

How will AFCA be governed?

The legislation requires AFCA to be governed by an independent chair and equal number of directors with industry and consumer backgrounds (matching the current governance structure of the FOS and the CIO).

The legislation also requires that the constitution of AFCA must provide the Minister with the ability to appoint a minority of the directors to the board, including the Chair, within six months of authorisation.

Ministerial appointments of a minority of the board recognise the enhanced role of Government in the establishment of AFCA (previously, EDR schemes were approved by ASIC). It has also provided Government with a means of shaping the inaugural board so it has an appropriate mix of skills and experience for the enhanced EDR mandate.

The Minister announced her appointments of the minority of the AFCA board on 1 May 2018. The remaining six directors were appointed by AFCL.

How will AFCA be funded?

AFCA's dispute resolution services will be free to complainants. AFCA's operations will be funded by its members — financial firms. Financial firms will be required by law to become members of AFCA (typically, as a condition of their licence to operate).

On 1 May 2018, the Minister announced that financial firms would be required to become members of AFCA by 21 September 2018.

How does AFCA compare with existing EDR schemes?

Expanded monetary jurisdiction

The Ramsay Review found that the monetary limits for existing dispute resolution schemes had failed to keep pace with the cost of typical financial products.

AFCA will be able to hear disputes in relation to monetary amounts ('monetary limits') higher than those which are currently allowed within the terms of reference for existing EDR schemes.

Specifically:

- For most non-superannuation complaints, there will be a monetary limit of $1 million and a compensation cap of $500,000.
- For small business credit facility disputes, the amount of the credit facilities can be up to $5 million, with a cap on compensation of $1 million. In the case of 'primary producers' (as defined by the *Income Tax Assessment Act 1997*), the compensation cap will be $2 million.
- For superannuation complaints, there will be no monetary limits or compensation caps.
- For disputes about whether a guarantee should be set aside where it has been supported by a mortgage or other security over the guarantor's primary place of residence, there will be no monetary limits or compensation caps.
- For general insurance broker disputes, the compensation cap will be $250,000.
- For income stream insurance product disputes, the compensation cap will be $13,400 per month.
- For uninsured third party motor vehicle claims, the compensation cap will be $15,000.

Apart from the monetary limits relating to superannuation disputes, monetary limits are not specified in legislation and will be set out in the AFCA Rules so that they can be updated over time, including in response to a direction from ASIC.

Enhanced ASIC oversight

The Ramsay Review recommended providing ASIC with greater and more nuanced powers to support its oversight of the single dispute resolution body. ASIC's existing powers included the ability to approve (including with conditions) or revoke authorisation.

Under the legislation, ASIC has the ability to issue legislative instruments relating to AFCA's mandatory operational, organisational and compliance requirements (for example, in relation to the kinds of issues that must be reported to ASIC), as well as to issue regulatory guidance.

Where AFCA fails to comply with a compliance requirement, ASIC has the ability to issue a direction requiring AFCA to take action so that it meets the compliance requirement.

The legislation also provided ASIC with two explicit directions powers to allow it to require AFCA to:

- increase its monetary limits and compensation caps; or
- raise more funds from members to ensure the scheme is adequately financed.

What remains to be completed before AFCA commences?

One of the early priorities of the AFCA Board will be to consult on draft term of reference known as the AFCA Rules and interim funding arrangements.

The Board will also work with financial firms on the process to formally become a member of AFCA by 21 September 2018.

FOS and CIO are making arrangements to transition to AFCL. The SCT will continue operating after AFCA's commencement to resolve the backlog of complaints on hand.

Ramsay Review Supplementary Report

In February 2017, the Minister for Revenue and Financial Services wrote to the Ramsay Review to extend their terms of reference to require them to report to Government on the establishment, merits and potential design of a compensation scheme of last resort, and the merits and issues involved in providing access to redress for past disputes.

In September 2017, the Ramsay Review provided its supplementary report to Government.

The Government released the report on 21 December 2017 and announced it would defer its consideration and response to the report until after the Royal Commission had concluded.