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Via email only: consultation@afca.org.au

Dear Ms Russell

Consultation on the draft Approach to Appropriate Lending to Small Business

The Banking Code Compliance Committee (BCCC) welcomes the Australian Financial Complaints Authority's (AFCA) consultation on the draft Approach to Appropriate Lending to Small Business document (the Draft Approach) and the opportunity to provide feedback.

This submission provides feedback on the Draft Approach's overlap with the small business lending obligations in the [Banking Code of Practice](#) (the Banking Code). We consulted with our [Small Business and Agribusiness Advisory Panel](#) (the Panel) in preparing this submission.

The BCCC has also provided a submission to AFCA's proposed Approach to Responsible Lending document, covering lending complaints brought by individual customers.

In our view, the Draft Approach provides comprehensive guidance on what AFCA decision makers will consider in a lending complaint raised by a small business. It also provides a clear assessment of how broader obligations, whether legislative, regulatory or industry code-based, can be practically applied to ensure fair outcomes for all parties.

The BCCC supports the Draft Approach and recommends the following improvements:

- Section 3.3 – Amend the wording in this section in reference to good industry practice.
- Section 3.5 – Provide additional guidance on AFCA decision makers' consideration of industry context as a relevant factor for the financial firm to consider in their credit assessment.
- Section 3.6 –
 - Include use of an individual guarantor as a circumstance that may require further inquiry.
 - Provide guidance on the use of external expertise when identifying circumstances where further inquiries would have been appropriate.

Banking Code Commitments on Appropriate Lending

Under [Chapter 17 of the Banking Code](#), code subscribing banks, who are also AFCA members, commit to the following obligations:

- Paragraph 49 - exercise the care and skill of a diligent and prudent banker when considering whether to provide new or increased credit
- Paragraph 51 – when assessing whether a small business customer can repay the loan, consider the appropriate circumstances reasonably known to the bank about:
 - the customer’s financial position, and
 - the customer’s account conduct.
- Paragraph 52 – owe an obligation to guarantors to comply with Paragraph 51.

To be considered a “small business” for the purpose of the Banking Code, a business must have:

- fewer than 100 full-time equivalent employees
- annual turnover of less than \$10 Million in the previous financial year, and
- less than \$3 Million in total debt to all credit providers including:
 - any undrawn amounts on existing loans
 - any loan being applied for, and
 - the debt of all its related entities that are businesses.

We note this definition of “small business” differs from that in the AFCA Rules. However, we expect the “small business” definition will be updated under the current Banking Code review, which we understand will align more closely (but not exactly) with the AFCA Rules definition.

BCCC Approach to Appropriate Lending

Under paragraphs 49 and 51 of the Banking Code, code subscribing banks have committed to ‘exercise the care and skill of a diligent and prudent banker’ when considering whether to provide or increase credit to a customer, and to consider the appropriate circumstances reasonably known to them about the customer’s financial position and account conduct.

When reviewing breach allegations from bank customers, we do not consider ‘diligent and prudent banker’ as a standalone obligation. As part of the Banking Code’s overarching commitments and stated outcomes, we will consider a bank’s commitment to exercise the care and skill of a diligent and prudent banker in conjunction with the bank’s obligations under paragraph 10: engagement in a fair, reasonable and ethical manner, as well as the Banking Code’s Guiding Principles to reach a holistic assessment of the bank’s compliance with the Banking Code.

In the case of small business customers, we also consider the obligations set out under Chapter 20 of the Banking Code, relating to information required from small business customers when they apply for credit and the provision of the terms and conditions of the loan by the bank prior to acceptance of a credit facility by a small business customer.

We also consider context-specific obligations such as protections for guarantors, accessibility or vulnerability, which we expect the bank to have considered when lending to the customer. The BCCC’s approach to assessing banks’ compliance with paragraph 10 and the Guiding Principles is found in [Guidance Note No. 2: Clause 10 – fair, reasonable and ethical behaviour](#).

Comments and Recommendations on the Draft Approach

Our specific comments on the Draft Approach focus on Section 3: How we decide if a financial firm has met its lending obligations.

We have not commented on loss and compensation as these matters do not fall within our remit.

Section 3.3 – Consider the financial firm’s obligations and good industry practice

The Draft Approach explains that AFCA may consider whether principles in a code reflect good industry practice more broadly within a particular industry or sub-sector, and therefore apply beyond subscribers to the code.

The ‘good industry practice’ on page 16 of the Draft Approach, in respect to expecting financial firms to undertake some form of assessment when providing credit, is reasonably consistent with paragraphs 49 and 51 of the Banking Code.

We recommend amending this sentence to remove ‘If an industry code does not apply’ and make it clear this is an example of good industry practice that applies beyond subscribers to the code.

Section 3.5 – Considering if the credit assessment was appropriate

We acknowledge that AFCA decision makers already take into account the industry outlook and market conditions of specific sectors at the time of the lending decision where it is relevant to consideration of the fairness of a financial firm’s credit assessment methodology.

This is reflected in the table of relevant factors or information AFCA decision makers may consider when analysing a financial firm’s credit assessment of a complainant on page 19 of the Draft Approach.

However, input from our Panel suggests that the industry-specific knowledge and experience of lending decision makers, particularly in specialised sectors such as agribusiness, can play a significant role in the quality and ultimate appropriateness of their credit assessment.

We suggest the inclusion of additional guidance and scenario-based examples in this subsection to highlight the importance of consideration of the characteristics of the borrower’s context, in small business credit assessments, where relevant.

Guidance on the role that industry-specific factors and knowledge can play in AFCA’s consideration of a credit assessment would also give financial firms a clear indication of when such considerations should be incorporated into their credit assessment methodologies. This may help improve the practices of financial firms and potentially reduce future complaints.

Section 3.6 – Considering if the financial firm should have asked for further information or clarification

We suggest that use of an individual as a guarantor to secure credit should be included in the table starting on page 24 of the Draft Approach as a circumstance that may warrant further inquiries from the financial firm.

Under paragraph 51 of the Banking Code, code subscribing banks may include the resources of third parties connected to the small business customer in their assessment of the customer's ability to repay the loan. This may include guarantors and other related entities. We also note that there are significant exceptions to the Banking Code's obligations relating to notification and information for guarantors¹.

The [BCCC's report on our inquiry into banks' compliance with the Banking Code's guarantees obligations](#) recommended that banks conduct face-to-face interviews with prospective guarantors. As set out in pages 25 and 26 of this report, the purpose of such interviews was to ascertain the prospective guarantor's understanding of the implications and risks of guaranteeing the proposed credit.

In the small business context, our view is that financial firms should, where appropriate, inquire of the prospective guarantor as to:

- their knowledge of the role and obligations of a guarantor
- their reasons for guaranteeing the proposed credit, and
- their understanding of the overall risks of securing credit for the business.

The BCCC recently released the report of our [Follow-up inquiry into guarantees compliance](#). This inquiry found that there remained inconsistency in banks' performance when it comes to informing prospective guarantors of matters required under paragraphs 96 and 97 of the Banking Code, relating to the potential risks of becoming a guarantor. The same inconsistency was found in implementing interviews with prospective guarantors, independent from prospective borrowers, to ensure that they were well informed.

In addition, our breach data includes instances where small business customers have relied upon friends or family, otherwise unrelated to their business, to guarantee their business credit. In one reported breach of the small business lending obligations, such a guarantor was required to cover shortfall debt after the customer's business failed within 18 months of the credit decision.

Friends or family members of small business customers who are guarantors of business credit can be subject to serious financial impact in the event that the customer defaults on their debts. To help avoid such outcomes, financial firms should ensure prospective guarantors enter into the guarantee with adequate knowledge of the overall risks of securing credit for that business.

In addition, feedback from the Panel recommends that AFCA decision makers exercise caution when considering whether information gaps or circumstances requiring further inquiry are present in a certain complaint. Standard industry criteria for lending may not capture more granular factors that are significant to the future viability of a specific business, such as location, sub-market segment, long term funding needs not captured by standard cash flow projections, or the financial position of related entities.

We suggest the Draft Approach highlight decision makers' ability to seek external advice from qualified independent experts, under rules A.9.6-7 of [the AFCA Rules](#), if required to make an informed decision on whether further inquiries from the financial firm would have been appropriate.

¹ Paragraph 97 – Obligation does not apply to commercial asset finance guarantors, sole director guarantors, or trustee guarantors.

Paragraph 100 – Banks must inform director guarantors that they are entitled to the notices and information required by paragraphs 96-99. Director guarantors can choose not to receive this information.

