Valiant

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Lead Ombudsman – Small Business and Transactions
Australian Financial Complaints Authority (AFCA)
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By email: consultation@afca.org.au

Consultation Paper regarding AFCA's draft Appropriate Lending to Small Business Approach

Valiant Finance Pty. Ltd. ("Valiant") (ABN 95 606 560 150) appreciates the opportunity to provide this feedback on the draft Approach to Appropriate Lending to Small Business ("the Draft Approach") proposed by the Australian Financial Complaints Authority ("AFCA").

Valiant is one of Australia's largest business finance intermediaries. We provide several services to help small businesses get access to debt finance, including direct brokerage services, research and submission software, and aggregation services into our lending partners. Valiant has expertise in arranging all major debt finance products used by small businesses, including fully secured commercial facilities, asset finance, and a range of working capital solutions. To date, Valiant has arranged over A$1.8 billion in business credit across over 90 business lenders including a range of major banks, online lenders and private lenders. We are an ACL holder (number 500 888) and employ a team of 130 people.

To carry out our service proposition to customers, Valiant uses a variety of technology and human assessment processes to recommend appropriate business credit. This includes technical assessment of business trading information, credit files, bank statements and a range of other financial documentation, and comparing this customer information to detailed lender requirements that we have gathered over years of close credit policy fact-finding with our lender partners. Valiant is involved in arranging business finance but does not underwrite credit; we believe we are uniquely positioned by virtue of our intermediary role, large lender panel and growing customer base, to offer a compelling perspective on small business lending.

We are deeply appreciative of AFCA's services to industry. At Valiant, we pride ourselves on being 'customer champions' for small-to-medium enterprises ("SMEs") and, consistent with that mission, we have only interacted with AFCA a handful of times (and in most cases successfully resolved the case or received favourable finding).

Overview of feedback on the draft approach

Valiant has significant concerns about the draft approach that it would like to communicate to AFCA. These concerns include that the Draft Approach:

1. Is in tension with the inherent difficulties in scalably and economically assessing small size business loans
2. Will create significant uncertainty and risk for business finance companies as currently drafted
3. Will create "consumer-like" responsible lending obligations where the legislation does not require it
4. Will result in a material and systemic increase in the cost burden of delivering business lending services
5. Will ultimately result in reduced lending appetite and greater difficulty for small businesses accessing credit
6. Will reduce competition and innovation in the small business lending industry
7. Will harm the broader small business economy

Given micro-SME's access to small business credit remains a significant challenge (and is subject to external shocks as demonstrated during the COVID pandemic), we highly recommend avoiding measures that reduce access to credit. To the extent AFCA remains convicted to introduce responsible lending measures for small business, we recommend that that they are narrow in scope, do not extend beyond the legislative position and are tightly and clearly defined – enabling business lenders to design systems that are compliant with AFCA's guidance.

Detailed feedback on the draft approach

AFCA's approach would impose several obligations on small business lenders that are in tension with the reality of SME lending, including:

- Undertaking meaningful serviceability analysis in a cost-effective way
- Making further inquiries to verify that a product or lending decision is fit for purpose

While these obligations appear fair on the surface, they are very difficult to carry out in a way that would not create unfair retrospective risk of an adverse AFCA finding under the draft approach. This is because:

- Many small businesses run bank accounts that mingle household and business expenses, making financial review of manual addbacks difficult and costly at smaller loan sizes. Other complications are introduced for the most common means of verifying business income and profit e.g., bank statements often contain unidentifiable debits and credits of material size, and accounts may be recapitalized from external accounts and drawn down for profit extraction in ways that materially affect balances and income calculations. This issue is exacerbated by the fact that debt will often lead to income generation, but many small businesses do not generate business plans for smaller loan sizes because capital is simply applied to a greater volume of their current core activity. Assessing business serviceability scalably in these circumstances often involves the thoughtful application of industry benchmarks and other conduct indicators (e.g., credit score) to triangulate credit grade given the inherent difficulties of undertaking accurate serviceability assessment

- The use of industry benchmarks are highly effective when refined over multiple years and underpin the core decision engines of many lenders. Critically, they enable scalable assessment at small loan sizes that could not otherwise justify assessment by a highly-paid credit professional. Benchmark outcomes may be at odds with real observed performance due to the serviceability assessment issues raised above but are nonetheless highly predicative of loan outcomes. Where benchmarks and observed performance clash, the Draft Approach may demand further inquiry and untangling of financial information that will never be economically viable at low loan sizes, incentivizing business lenders to simply not offer credit at these loan sizes
- The small business lending industry relies heavily on "low documentation" loans and management of risk at a portfolio level to overcome scalability challenges. All major asset lenders have products that reward strong GST-registered trading history, low credit scores, and good existing credit conduct and specifically avoid detailed serviceability analysis. These low documentation products are heavily desired by customers (who incur real labour and opportunity costs assisting lenders with detailed financial analysis) and lenders seeking to provide access to credit

The issues raised above are illustrative but not exhaustive in demonstrating the esoteric nature of small business loan assessment, particularly at small loan sizes and in specialized product areas like asset finance. The broadly framed requirements of the Draft Approach would leave business lenders in a position of significant financial uncertainty as to the compliance of many of their existing core assessment processes. Given overall portfolio returns are highly sensitive to losses (particularly in narrow margin products like vehicle lending), systemic risk that AFCA may make adverse findings across low documentation decisions or benchmark-based assessment could significantly contract lending in these areas and result in undesirable economic outcomes.

A caveat to our general feedback is that some of AFCA's requirements (particularly those that relate to the potential requirement to exercise the skill and care of a diligent and prudent banker) may be justified at larger loan amounts (particularly in the $1m+ loan market). We think it is telling that major banks that are active participants in the Code of Banking Practice operate predominantly at these larger loan sizes and only have limited operations in micro-SME lending. We believe that AFCA importing similar standards to smaller loan sizes results in untenable economics on these smaller transactions and will affect access to credit.

These concerns about the impact on business lending are well-founded. Recommendation 1.9 of the final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry concluded "*The NCCP Act should not be amended to extend its operation to lending to small businesses*". The reasons for this recommendation are stepped out on pp 94-96 of the final report and include "r*ecognition of the need to ensure that small businesses have access to reasonably affordable and available credit*" and that "*extending the responsible lending obligations in the NCCP Act would likely increase the cost of credit for small business and reduce the availability of credit*". While the commentary goes on to note many of the other sources of obligations that are relied upon by AFCA for the Draft Approach, the commentary does not appear to support the application of the Banking Code to non-participants in the code.

While the Draft Approach is expressly not providing for the extension of the NCCP Act to business lending, it has the risk of creating all the harms that Recommendation 1.9 seeks to avoid. This is because:

- The Draft Approach uses similar language around potential assessment requirements to consumer lending
  - AFCA's considerations of whether a credit assessment was "appropriate" list relevant factors that are akin to the consumer requirement to undertake detailed assessment of a customer's financial situation and objectives in providing credit advice
  - AFCA's examples of whether a loan product was "appropriate" go well beyond the product type being suited to the business's request. In the page 23 example of the Draft Approach (Ezra's car wash loan), the requirement of the lender to make further inquiries into gaps in assumptions in a business plan (specifically the absence of a site operator cost) are very similar to the further inquiries requirements of consumer lending for household expenditure. Notably, these requirements (if interpreted in a similar manner) are far more onerous in business lending, as the particular requirements of a business are industry and scale-specific compared to the basic General Living Expense categories used for consumer lending
- The pp19-20 list of potentially relevant factors that AFCA would consider in determining if the credit assessment was "appropriate" could easily import the requirement that credit be "not unsuitable", which is the ongoing standard of the NCCP Act for non-mortgage lending
  - The NCCP Act negative requirement that credit be "not unsuitable" means that, practically, only unsuitable credit is in breach of the Act
  - AFCA's assessment requirements ostensibly arrive at a very similar outcome via the broad list of considerations that a lender may need to take into account in advancing credit

Combining the above factors, AFCA's Draft Approach may require similar investigation standards into financial situation and objectives to consumer lending and similar standards regarding the subsequent assessment that credit is not unsuitable. We believe that this may have the practical effect of extending NCCP Act standards to business lending, despite clear government recommendations to the contrary. Even if AFCA would not apply these standards to the same bar under its discretion, business lenders will need to design systems and processes that obviate the risk of a costly adverse finding. This may have the damaging impact on business credit availability that the royal commission (and its economic and regulatory advisers) sought to avoid.

To the extent that the application of the Draft Approach's "relevant factors" are highly discretionary by AFCA, we suggest that AFCA closely consider if its complaints conciliators have the industry-specific expertise to fairly make these determinations. As noted above, determining what is an appropriate lending determination requires a detailed understanding of:

- The reasonableness of a lender making a determination on relative impact of different credit factors e.g., pre-existing credit conduct vs observed business profitability
- Benchmarks and key performance indicators at granular industry levels (e.g., what is a sufficient number of customers to de-risk income for a building and trade business varies materially to a hospitality wholesaler). Valiant categorises over 4,000 different industry descriptors for this reason
- Common financial statement addbacks and personal/business expense mingling undertaken by small business owners
- How to account for the lack of modelled financial projections developed and provided by micro-SMEs for nearly all lending scenarios outside business acquisitions (e.g., micro-SMEs do not model forward cashflow when they purchase a new business vehicle)
- Specialised lending products (e.g., greenfields vs established franchise businesses, debtor and trade finance, fully bespoke structured private lending etc)

In our limited experience with the AFCA complaints process, the AFCA conciliators are skilled interpersonal mediators, but do not demonstrate this credit assessment expertise. This raises significant concerns about the practical application of the Draft Approach where there is material discretion as to what is fair, reasonable or prudent in a given business lending complaint scenario.

Potential impact on access to credit

Implementation of The Draft Approach could result in a significant reduction in access to small business credit across multiple business lending product areas. The following impacts are foreseeable given the concerns outlined above:

1. Small loan size unsecured lending may become less available – these loans are highly dependent on scalable, benchmark-based assessment approaches that manage risk at a portfolio level. Consideration of AFCA's "relevant factors" at these loan sizes risks making these loans economically untenable for lenders
2. Small business ease in applying for and supporting their credit assessment may be harmed – small businesses rely upon using low documentation products, particularly in asset finance, to access affordable credit quickly and easily. Full documentation processes that assess financials and business plans are the exception rather than the norm, and these processes require investment of multiple hours of labour from busy small business owners whose labour is the main income-generator in their core business. Full documentation processes require them to coordinate with accountants for financial statements, BAS and tax statements, create business planning documents, and go through interview and interrogation processes with lenders assessing these documents
3. Asset finance may become less available – asset finance is a key economic enabler given the role of capital assets in unlocking business productivity. As noted above, these products overwhelmingly utilize low documentation processes that manage risk using the capital value of the asset rather than undertaking detailed serviceability analysis
4. Competition in the small business lending market may be reduced - the Draft Approach relatively benefits bank lenders targeting larger loan amounts that benefit from individual deep assessment by professional business bankers.

Their ability to manage and de-fray the adverse finding uncertainty inherent in the Draft Approach through scale is also significant. Smaller, non-bank lenders seeking to serve niche product requirements are a critical part of Australia's business lending ecosystem. These lenders will be most disadvantaged in seeking to alter systems and processes to comply with the Draft Approach

5. Innovation in the Australian business lending market may be lessened - bringing technology and scalability to the business lending market is important in improving access to credit for small businesses. Some of the methods stepped out above, and many more, are used to address the esoteric challenges of assessing small business creditworthiness and serviceability at smaller loan amounts, and to enable rapid approvals that benefit the vast majority of applicants. The Draft Approach introduces significant downside risk and uncertainty to innovating in delivering business lending services

Summary

Valiant would like to extend our gratitude for the opportunity to consult on the Draft Approach. We are passionate about helping small business access the best possible credit and participating in a thriving business lending industry. We also recognise the important role that AFCA plays in providing independent recourse for lending customers. We hope that our feedback helps to inform changes to the Draft Approach that allows business lenders to design their systems and processes with certainty, thereby minimising the potential impact to the availability of small business credit.

We are available to provide further commentary or answer any questions about this consultation paper upon your request.