# Re: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

## Written Submissions of the Australian Prudential Regulation Authority (APRA)

## Round 3: Loans to small and medium enterprises

### Introduction

1. Pursuant to an application made by APRA on 11 May 2018, APRA was granted leave to appear at the Royal Commission hearings commencing on 21 May 2018 (Round 3).

2. The focus of Round 3 has been on the practices of individual institutions relating to lending to small and medium enterprises (SME) and on the consumer protection framework governing such lending. These matters are not directly within APRA's mandate. However, matters relating to the prudential framework arose during the hearings about which APRA has views that might assist the Commissioner.

### Regulatory capital requirements and the Code of Banking Practice

3. One such matter is the impact of APRA's capital requirements for SME exposures on smaller authorised deposit-taking institutions' (ADIs') ability to compete and whether this might be compounded by proposed revisions to the definition of 'small business' in the Australian Banking Association Inc's (ABA) Code of Banking Practice (the code).

4. Testimony by the ABA suggested the operation of APRA's regulatory capital requirements in the case of smaller ADIs was a relevant factor in determining whether the definition of 'small business' in the code should be set at an aggregate lending level of $3 million or $5 million[1]. As noted by Counsel Assisting[2] the monetary threshold of below or above $5 million makes no difference to what risk weighting APRA applies to a business loan. It is APRA's submission that minimum capital requirements are not, and should not be

[1] Transcript 2916.10, 2918.1-11

[2] Transcript 2917.37-44

presented as, relevant to determining the appropriate definition of small business to be used in the code.

***Regulatory capital requirements***

5. As set out in Background Paper 9, *The regulatory capital framework for authorised deposit-taking institutions (ADIs),* APRA's prudential framework provides two methodologies for determining regulatory capital for credit risk: the standardised approach and the internal ratings-based (IRB) approach. Under the standardised approach, exposures to SMEs that are not secured by residential real estate are typically risk weighted at a flat 100 per cent. More risk sensitive, the IRB approach does not apply a flat risk weight but allows the ADI, subject to APRA's approval, to use its own internal financial models and experience data to determine risk weights, which may also change over time based on that experience data. Under parts of the framework, ADIs using the IRB approach are subject to additional capital requirements that do not apply to ADIs using the standardised approach. For SME lending, however, average risk weights for SME lending under the IRB approach are lower than those under the standardised approach[3]. In other words, IRB ADIs typically need to hold less regulatory capital against an IRB exposure than an ADI using the standardised approach for an equivalent exposure.

6. As detailed in the February 2018 discussion paper *Revisions to the capital framework for ADIs*, APRA is proposing to narrow the difference in regulatory capital requirements for SME exposures between the standardised and IRB approaches.[4] The revised risk weight framework is likely to lessen any competition impacts of differing regulatory capital requirements between large and small ADIs, potentially improving the competitive position of the latter.

7. Regulatory capital is not, however, the only factor affecting ADIs' ability to compete. For example, an ADI's risk management capabilities (particularly in relation to credit risk), risk appetite, access to funding, access to capital, funding costs, and geographic and industry risk diversification will all have an impact on its ability to compete in any particular lending sector.

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[3] Background paper 9 pp 9 - 12

[4] Discussion paper: *Revisions to the capital framework for authorised deposit-taking institutions (ADIs).* Available at: https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia

***The Code of Banking Practice***

8. A point raised in Round 3 concerned recommendations to expand protections under the code relating to the provision of credit to a broader set of business borrowers than under the current code, namely, businesses that employ more than 100 employees with a credit facility up to $5 million. APRA understands that ABA members (including, notably, IRB banks) do not support extending the credit provisions of the code to facilities up to $5 million.[5] In evidence to the Commission, the ABA suggested that adopting this threshold would apply the code provisions to most of smaller ADIs' business books, which primarily consist of small business loans under $5 million.[6] This is in contrast with IRB banks, where small business loans under $5 million are a smaller proportion of business lending and business lending overall is more diversified. This difference in coverage is reflective of the size and scale of the respective sets of ADIs, rather than a product of the regulatory capital framework *per se*.

9. The ABA also gave evidence that the smaller ADIs are also concerned that the proposed code provisions would limit available enforcement mechanisms for larger facilities, thereby reducing their appetite to extend these loans, at all or on terms competitive with those offered by larger institutions[7]. Again, this concern on the part of smaller ADIs appears to be a product of the difference in risk appetite that comes from the greater diversification and capital resources available to larger ADIs, rather than a product of regulatory capital requirements.

10. APRA therefore does not agree that there is a connection between its regulatory capital requirements and any decisions regarding the definition of small business to be incorporated into the code, and no such connection should be made.

11. As with any other regulatory change, ADIs may decide to make changes to their business activities to accommodate direct and indirect impacts of that change. ADIs (and other lenders) have historically included financial covenants and non-monetary default conditions in loan agreements to control credit risk by providing the lender with the option to intervene where indicators of creditworthiness deteriorate beyond thresholds agreed with the borrower at loan origination. The code will limit the use of these measures, which

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[5] Transcript 3057.34 -

[6] Transcript 2916.41-46, 2918.1-6

[7] Transcript 2915.28-40, 2916.45 - 2917.1, 2918.28 - 35

might, for example, lead an ADI to consider at least four possible actions, individually or in combination:

(a) an ADI may reconsider its willingness to lend, with the marginal borrower possibly no longer able to obtain finance;

(b) where additional collateral is available, an ADI may look to take greater security for its SME credit exposures;

(c) an ADI may increase the interest rates they charge for SME credit to compensate for the additional losses that might be expected; and/or

(d) loan terms may be shorter so that an ADI is able to reassess the creditworthiness of a borrower on a more regular basis, reducing the certainty of funding for SME borrowers.

12. Ultimately, however, an ADI's decisions about lending, at all or on revised terms, is a matter for the ADI, taking account of its risk appetite, business strategy and other factors unrelated to whether it is subject to the standardised or IRB approaches to credit risk.

13. For the reasons given, APRA has no preference as to the monetary threshold under which the code would apply to small business. There may, however, be merit in aligning any definitional criterion with sound business practices: typically, an ADI makes lending decisions on an aggregated (total credit provided) basis rather than on a facility-by-facility one. Defining by reference to individual facilities may also mean that a larger business could unintentionally benefit from code provisions by having a series of individual facilities with different lenders. That said, APRA also understands that the Australian Financial Complaints Authority may deal with complaints about a credit facility of up to $5 million and there may be merit in aligning redress opportunities for borrowers with the code's protections.

14. APRA also observes that the appropriate balance between the benefit of affording small business borrowers additional protection and the costs of doing so is, in the absence of acquired experience, difficult to ascertain and a question of judgement. One potential effect to be considered in undertaking this balancing is that ADIs not subject to the code and non-ADI lenders will have an arbitrage opportunity through having the ability to lend with more enforcement options such as non-monetary default conditions.

**Matters relating to the Commonwealth Bank of Australia**

15. Round 3 canvassed matters on which APRA might provide contextual information to assist the Commissioner relating to its recent actions in relation to the Commonwealth Bank of Australia (CBA) and relating to CBA's actions following its acquisition of Bank of Western Australia (Bankwest).

***Bankwest***

16. Bankwest, supported by the strength of its parent HBOS PLC, pursued an aggressive expansion strategy prior to the global financial crisis. However, once parental support was no longer available, Bankwest's strategy was no longer viable. Given CBA already had a lower risk appetite than Bankwest, and this was further reduced following the difficult conditions in the immediate aftermath of the global financial crisis, we agree with Counsel Assisting's view that CBA's decision to undertake a review of the Bankwest business lending portfolio was both prudent and responsible.

***Prudential Inquiry into the Commonwealth Bank of Australia***

17. Round 3 explored the failure of CBA's risk management function to prevent and address problems in a timely manner and delays in improving that function. Similar themes were considered by the panel appointed by APRA in August 2017 to conduct a prudential inquiry into the CBA group, which identified, among other things, deficiencies in CBA's management of non-financial risks, i.e. its operational, compliance and conduct risk.

18. Although the panel did not focus on Bankwest or SME lending specifically, its final report did make various findings and recommendations relating to CBA's treatment of customers that align with matters raised in Round 3.[8] For instance, the report highlighted weaknesses in governance practices, Executive Committee dynamics, reporting of customer issues, identification, escalation and remediation of systematic issues, and pre-emptive investment in systems. The report noted two case studies where inadequate weight had been given to customer outcomes (CommInsure and credit card insurance), and noted a tendency of the CBA group to focus on aggregate measures of customer satisfaction as opposed to the 'long tail' of outlier customer experiences. Ultimately, the recommendations

[8] A copy of this report, *Prudential Inquiry into the Commonwealth Bank of Australia,* and accompanying documents are available at: https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu

included asking CBA to embed the “should we?” question in all dealings with, and decisions relating to, customers.

19. CBA has entered an Enforceable Undertaking to provide a remedial action plan, under which CBA will satisfy APRA that the recommendations are effectively addressed. Some recommendations (e.g. those going to customer outcomes) are beyond APRA’s core prudential mandate. For these recommendations, ongoing assessment of recommendation closure will be conducted in consultation with ASIC.

Australian Prudential Regulation Authority