

Our ref: BLC:EEIb1749842

28 June 2019

General Manager
Policy Development
Policy Advice Division
Australian Prudential Regulation Authority

By email: ADIpolicy@apra.gov.au

Dear Sir/Madam,

Proposed revisions to the credit risk management framework for authorised deposit-taking institutions

The Law Society of NSW appreciates the opportunity to comment on the Discussion Paper "APS 220 Credit Risk Management" and the draft prudential standard "APS 220 Credit Risk Management" ("draft Prudential Standard"). The Law Society's Business Law Committee contributed to this submission. The Law Society's concerns have also been shared with the Law Council of Australia.

The Law Society acknowledges that the Australian Prudential Regulation Authority ("APRA") is considering appropriate updates to the *Prudential Standard APS 220 Credit Quality* ("APS 220") including re-naming it as APS 220 Credit Risk Management to:

- better describe the purpose of the revised standard, which is broader than APS 220, covering credit standards and the on-going monitoring and management of an authorised deposit-taking institution's credit portfolios in more detail,
- cater for a new accounting standard AASB 9 *Financial Instruments* that uses a forward-looking approach to provisioning,
- take account of updated supervisory guidance issued by the Basel Committee on Banking Supervision, associated with the new accounting standard on sound credit practices and asset classifications, and
- make other changes following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ("Royal Commission").

APS 220 sets out APRA's prudential standard for ADIs in managing their credit risk frameworks including when assessing applications for loans and credit.

The Law Society notes that APS 220, both in its current form and as proposed in the draft Prudential Standard, deals with an ADI's own credit risk position. It includes processes at a borrower level where an ADI is expected to exercise prudent credit judgement commensurate with the nature, size and complexity of the transaction when approving new loans and credit and when reviewing and refinancing existing exposures.

Paragraph 44 in the draft Prudential Standard lists criteria ADIs must consider when a new loan or credit is to be provided to an individual as a borrower. Paragraph 45 provides additional criteria to those in paragraph 44 to be considered when the borrower is not an individual. Consequently, the criteria to be applied under the draft Prudential Standard for new loans and credit to small-to-medium enterprises ("SMEs") includes the same criteria in paragraph 44 as is applied to individuals in addition to the criteria in paragraph 45.

The criteria list in paragraph 44 appears to the Law Society to reflect the requirements of the Australian Securities and Investments Commission ("ASIC") in Regulatory Guide 209 *Credit licensing: Responsible lending conduct* ("RG 209"), which sets out guidelines for credit providers to meet their obligations under the *National Consumer Credit Protection Act 2009* ("NCCP"). The Law Society notes, however, that neither the NCCP nor RG 209 apply to loans or credit provided to SMEs. Aside from the provisions of the *Competition and Consumer Act 2010* prohibiting misleading and deceptive conduct and unfair contract terms, there is no equivalent regime for SMEs to that of the NCCP for consumers.

However, despite this, and because there are no guidelines from ASIC or APRA on responsible lending practices where the customer is an SME, the Law Society is aware that it is often the practice of ADIs (particularly since the Royal Commission) to seek to apply the responsible lending guidelines set out in RG 209 as applicable for consumers, to SME customers who apply for loans or credit.

The inclusion of the same criteria as proposed by APRA in paragraph 44 of the draft Prudential Standard will require ADIs, in order to comply with their own obligations, to similarly apply those criteria to SMEs for new loans or credit.

The Law Society is strongly of the view that the responsible lending guidelines for consumers are not appropriate to be applied when an ADI assesses the ability of an SME to service debt or repay any new loan or credit. We consider that the draft Prudential Standard should not require the criteria in paragraph 44 to be applied to SMEs in addition to the criteria in paragraph 45.

Likewise, the Law Society notes that the NCCP, and as a result the responsible lending obligations of Australian credit licence holders and ADIs under RG 209, only applies to new loans issued from 1 July 2010, or to extensions of credit under loans existing as at 1 July 2010. The Law Society is aware that ADIs are currently applying the responsible lending obligations under RG 209 to borrowers who already held loans as at 1 July 2010, even where those borrowers have not applied for a new loan or extension of credit under those pre-existing loans.

The Law Society considers that the responsible lending obligations set out in RG 209 and the proposed criteria to be included in paragraph 44 of the draft Prudential Standard are not appropriate for the assessment of the credit risk to the ADI on loans and credit provided to SMEs. ADIs should assess their internal credit risk on loans and credit to SMEs based upon the credit assessment information relevant to a particular SME, noting that credit assessment information will vary considerably between SMEs.

The Law Society also considers that those RG 209 obligations and the proposed criteria to be included in paragraph 44 of the draft Prudential Standard should not be applied by ADIs for their own internal credit risk assessment of customers with pre-existing loans unless the customer has applied for an increase in credit under that loan. The Law Society recognises particularly that customers with loans pre-existing as at 1 July 2010 are already in the ADI's credit risk profile and, unless additional credit is provided, the risk assessment under that profile shouldn't change.

Options

The Law Society, subject to the comments and suggestions made above, supports APRA adopting Option 3 in the Discussion Paper, a broad update of APS 220 to reflect best practice credit risk management expectations, as being the most appropriate policy option in reviewing APS 220.

Further discussion

If you have any questions about this submission, please contact Liza Booth, Principal Policy Lawyer, at [REDACTED] or on [REDACTED].

Yours faithfully,

[REDACTED]

Elizabeth Espinosa
President