



The definition of 'small business'
Independent Review | 26th October 2020

Pottinger

Contents

1. Executive summary and recommendations	4
1.1 Purpose of the review	4
1.2 Overview of our approach to the review	4
1.3 The small business sector in Australia.....	5
1.4 Key findings	6
1.5 Our recommendations in relation to the Code	7
1.6 Other measures to support the Code and increase its impact	11
1.7 A note of appreciation.....	12
2. Purpose of the review	13
2.1 Background to the review	13
2.2 The Banking Code of Practice	13
2.3 Objectives of the review.....	14
2.4 Entities which are impacted by the definition of small business	15
2.5 The extent and nature of companies impacted by these definitions	18
2.6 Framework for addressing the issues raised by the review and inputs to our work	27
2.7 Our approach to stakeholder engagement	28
3. Desktop research and analysis	29
3.1 Overview of the definition of small business	29
3.2 Nature and extent of businesses protected by the Code.....	29
3.3 Extent of application of the Code.....	32
3.4 Nature of protections available to small businesses under the Code.....	33
3.5 Consideration of the criteria used by the definition	35
3.6 The values used in the criteria	36
3.7 Application at an individual company or group level.....	38
3.8 Application at a facility or aggregate borrowings level.....	39
3.9 Definitional issues identified during our review	39
3.10 Observations and conclusions.....	40
4. Findings from previous reviews	41
4.1 A brief history of the definition of small business.....	41
4.2 The Khoury Review	42
4.3 The Hayne Royal Commission	43
4.4 The ASBFEO Inquiry into Small Business Loans	44
4.5 Observations and conclusions	45
5. Stakeholder engagement findings	46
5.1 Overview of our approach to stakeholder engagement	46
5.2 Key issues for stakeholder engagement.....	47
5.3 Findings from our stakeholder engagement discussions	47
5.4 An overview of written submissions provided to Pottinger.....	50
5.5 Findings from our public stakeholder questionnaire	52
5.6 Observations and conclusions.....	53

6.	Overall observations and recommendations.....	55
6.1	Introduction and summary of findings.....	55
6.2	The Code as a minimum standard for bank behaviour	55
6.3	Recommendations related to the criteria used by the definition.....	56
6.4	Recommendations related to the values used in the criteria	58
6.5	Recommendations related to application of the criteria to groups of businesses	61
6.6	Recommendation related to application of the borrowings limit	63
6.7	Recommendations on categories of business to be excluded from the Code.....	64
6.8	Observations on other measures to support the impact of the Code	65
6.9	Timing considerations	67
6.10	Implications of our recommendations	67
6.11	Alignment with other definitions of small business.....	68
6.12	Conclusion and acknowledgements.....	69
7.	Index to figures	70

Pottinger is an independent, employee-owned corporate advisory firm dual headquartered in Sydney and New York City. We provide advice to private and public sector organisations on strategy, public policy, M&A, joint ventures, risk and innovation to help companies and communities increase growth, reduce risk and accelerate impact. For further information, please visit Pottinger.com.

1. Executive summary and recommendations

1.1 Purpose of the review

The Code of Banking Practice came into effect on 1st November 1996. Since then, it has been updated and revised on several occasions, most recently through a comprehensive rewrite following the findings of the Khoury Review and the Hayne Royal Commission, as well as other subsequent reviews.

The Banking Code of Practice (2019) (the “Code”) sets out standards of behaviour that banks should follow in their dealings with consumers and small business customers. It includes specific protections for small businesses, including simplified loan documentation, greater notice of enforcement action and enhanced transparency. Currently, the 22¹ bank members of the Australian Banking Association (the “ABA”) account for approximately 89%² of the assets in the Australian banking system.

The Code is the first substantive industry code to be approved by the Australian Securities & Investments Commission (“ASIC”) under the Corporations Act 2001, and the ABA has sought and obtained approval for all subsequent changes to the Code. ASIC’s original approval of the Code was subject to the ABA agreeing to commission an independent review of the definition of small business in the Code within 18 months of the Code’s commencement.

Accordingly, in September 2020, the ABA appointed Pottinger to conduct an independent review of the definition of small business under the Code. The objectives of our review are to determine whether, and if so how, the definition of small business should be updated, including consideration of:

- The relevance of the criteria used by the definition, ie annual turnover, employee numbers and borrowings outstanding;
- The values used in the criteria, currently A\$10m for annual turnover, 100 for full-time employee numbers and A\$3m for borrowings;
- Whether the criteria should be applied at an individual entity or group level, as well as the definitions used to determine which related entities should be taken into account in defining a group;
- Whether the criteria related to borrowings should apply solely to the facility in question or to the aggregate of all outstanding facilities; and
- The potential impact of any proposed changes to the criteria and/or the values, both in terms of overall materiality in the context of the banking system and in relation to the practicalities of implementing any proposed changes.

Further information including our terms of reference are set out in section 2.

1.2 Overview of our approach to the review

To assess these issues, we have undertaken our own desktop research and analysis, taking into account data sourced from the Australian Bureau of Statistics (“ABS”), the Australian Prudential Regulation Authority (“APRA”) and ASIC as well as other sources, as set out in section 3. We also considered the previous recommendations and observations on relevant matters made by the

¹ The 22 ABA members can be found at this link

² APRA - Monthly authorised deposit-taking institution statistics (August 2020)

Hayne Royal Commission, the Khoury Review, the ASBFEO Inquiry into Small Business Loans and the Council of Financial Regulators, as summarised in section 4.

In addition, we have also completed a stakeholder engagement exercise, consulting with a wide range of stakeholders as summarised below.

Figure 1: Overview of stakeholders consulted



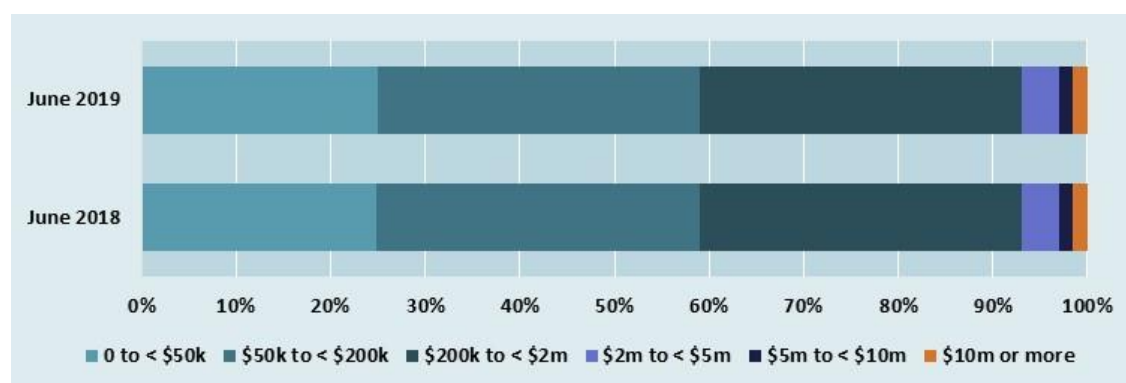
We also gathered perspectives from the public via a stakeholder questionnaire. The findings from our stakeholder engagement process are set out in section 5.

1.3 The small business sector in Australia

Small businesses are critical to the Australian economy. For example, of the 884,821 businesses recorded by ABS at June 2019 as having employees, 823,715 or 93% employed fewer than 20 employees. Only 4,271 or 0.5% employed 200 or more people. Data is not available for the number of businesses with fewer than 100 employees, as ABS does not report this figure.

Meanwhile, at the same date, 98.4% of all businesses recorded had turnover less than A\$10m³, ie would satisfy this criterion of the definition of small business under the Code.

Figure 2: Proportion of businesses with revenues in the band indicated⁴



Figures in Australian dollars. Source: Pottinger analysis of ABS data

It is not possible to tell from ABS data the number of businesses that have both turnover of under A\$10m and fewer than 100 employees as the data is not presented in this manner. Even if there was no overlap between these categories, however, it is clear that at least 95% of businesses will meet both tests if these are applied on a legal entity basis.

³ Source: ABS data - ABS 8165

⁴ Source: ABS data - ABS 8165. Figures exclude companies that have no employees

1.4 Key findings

Our overall observations and the recommendations which follow reflect a synthesis of our desktop research and background knowledge of the banking sector, consideration of the various previous reviews and our stakeholder engagement exercise. Our recommendations are also informed by the challenging operating environment brought on by the COVID-19 crisis.

As an important overarching observation, there is widespread support for the Code and widespread recognition of its importance in providing protection to small businesses in Australia. Importantly, most stakeholders consulted believe the Code represents a set of minimum standards of behaviour to be observed by banks in dealing with their small business customers.

There is broad consensus that the criteria used in the definition (turnover, employee numbers and aggregate borrowings) are both reasonable and appropriate, and that these tests should be assessed at a group level, rather than at an individual legal entity level. Not all stakeholders support these views, with some preferring to reduce the number of criteria that are used in the definition and/or recommending that the aggregate borrowings criterion should be applied at an individual facility level.

Meanwhile, there are several areas where there is broad support for the Code to be refined, including in relation to:

- Improving the precision of some of the terminology used, so that there is greater clarity and consistency regarding which enterprises are treated as small businesses;
- Giving small businesses greater confidence and transparency regarding whether or not they are (and will continue to be) treated as a small business by any particular bank; and
- Contributing to reducing the number of different definitions of small business that are used in Australia and clarifying why different definitions are used by different bodies.

The current definition of ‘related entities’ used by the Code is drawn from the Corporations Act 2001. Related entities include a broad set of legal and natural persons, including relatives, beneficiaries under a trust, trustees and related bodies corporate (ie other corporate legal entities). The definition of ‘related entities’ does not, however, include legal entities which are affiliated or organised under certain joint venture or partnership structures.

This definition results in some small businesses being inappropriately excluded from the protections of the Code, such as small agricultural businesses that operate independently but which are owned by members of the same extended family. The definition can also result in some businesses that are part of large, sophisticated groups being treated as small businesses. This issue cannot simply be addressed by applying all three criteria at a group level but rather will require changes to the definition of small business itself.

Meanwhile, there are some categories of business that are demonstrably sophisticated in nature and whose ability to access relevant institutional banking products may be inhibited by being classed as a small business. There is thus a case for such businesses to be automatically excluded from the protections of the Code.

Almost every stakeholder expressed the view that there are too many conflicting definitions of small business. There is near unanimous agreement that this causes considerable confusion for customers and that there would be considerable merit in reducing the number of definitions in use in Australia. In practice, however, there is no simple way to do this, as the various definitions are used for a variety of different purposes. No stakeholder made recommendations as to how simplification could be achieved.

In addition, we identified several areas which represent, or may be perceived to represent, loopholes in the definition of small business and how this is applied by banks. These have potential to cause further confusion to customers and to create reputational risk for banks which subscribe to the Code. One particular issue is that it is not straightforward for an enterprise to determine whether or not it qualifies to be treated as a small business under the Code, as this requires knowledge of the Code, the Corporations Act 2001 definition of related entities and aspects of the Australian Financial Services regime.

Given the importance attached to the issues of simplicity and transparency, we have included in our report suggestions as to measures that could be implemented by stakeholders to help to help mitigate these challenges.

Finally, there is also broad support for increasing the borrowing limit to A\$5m in due course. Some banks have already made this change. We acknowledge that there is little consensus regarding whether this change is worthwhile, and two medium-sized banks have expressed the view that any such change could have an adverse impact on competition and access to credit, though these views were neither definitive nor supported by specific evidence.

As an overarching matter, most stakeholders consider supporting more small businesses, rather than fewer such enterprises, to be an appropriate guiding principle. This is especially relevant having regard for the challenging operating environment brought on by the COVID-19 crisis. This approach is consistent with the operating practice of many banks to apply just one, rather than two or all, of the criteria used in the current definition of small business to determine a customer's eligibility for protection under the Code.

Our review addresses the definition of small business under the Code and certain related matters. We note that the current version of the Code only became effective from 1st March 2020, and that a wider review of the Code is due to be undertaken in 2021.

In the following sections, we summarise our recommendations in relation to the definition of small business in the Code and set out further measures that could be implemented by relevant stakeholders to support the Code and increase its impact.

1.5 Our recommendations in relation to the Code

The recommendations set out below address the issues we have identified, whilst giving appropriate consideration to the extent of impact (or otherwise) that any proposed change might have on the number of customers protected, the level of transparency achieved, and the cost, complexity and risk of implementation for the banks and other relevant stakeholders.

Figure 3: Summary of recommendations

Area	Recommendations
The criteria and values used	1 The criteria used by the definition of small business should be retained
	2 An enterprise should continue to be required to meet all three criteria to qualify as a small business
	3 The values related to employee numbers and turnover should be retained
	4 The value used in the borrowing criterion should be increased to A\$5m in due course
Related entities	5 All three criteria should be applied at a group level
	6 The definition of related entities should be refined
Aggregate borrowings	7 The borrowings criterion should continue to apply to aggregate borrowings

Area	Recommendations
Exclusions	8 Certain categories of sophisticated business should be specifically excluded
Implementation	<p>9 The ABA should endorse our recommendations in the near term and implement them as soon as practicable</p> <p>Two recommendations, namely the application of all three criteria at a group level (rather than an individual legal entity level) and the exclusion of certain types of sophisticated enterprise can readily be implemented more rapidly and accordingly we recommend that the Code be updated to address these in the near term</p> <p>Implementation of the other recommendations can commence following completion of the upcoming review of the Code, thus allowing sufficient time for banks to prepare and to ensure that all relevant implications are properly considered in advance</p>

We provide further detail on these recommendations and the rationale for proposing them in section 6. Whilst most of the above recommendations are straightforward in nature, there are four that merit particular attention, as summarised below.

Aggregate borrowings: Unlike the Khoury Review, Hayne Royal Commission and ASBFEO Inquiry, we recommend that the credit criterion is based on aggregate borrowings, rather than on an individual facility limit. The reason for this is that the fundamental purpose of the Code is to protect unsophisticated customers, rather than to enforce simplified documentation or other requirements on particular products. Our view is that aggregate borrowings represents a better measure of sophistication than the size of individual facilities. In addition, the use of a facility limit would result in sophisticated organisations with large borrowing requirements that are implemented through a series of smaller facilities being classified as small business customers.

The credit threshold: We acknowledge that there has been substantial debate and discussion in relation to the recommendation by previous reviews that a value of A\$5m should be used in the borrowings criterion, and that this ultimately resulted in a figure of A\$3m being used in the Code. On balance, and in conjunction with our view that the borrowings criterion should be based on aggregate borrowings, we recommend that in due course the Code should be updated to refer to an aggregate borrowings amount of A\$5m. We note that the ABA's submission, made on behalf of its member banks including all subscribers to the Code, opposed this change⁵. Meanwhile, some banks and associated stakeholders emphasised that any such change should only be implemented after an appropriate preparatory period. Importantly, however, in our direct consultations with most of the banks that subscribe to the Code, no banks opposed such a change outright. This would extend the protections of the Code to a modest number of additional businesses, in line with estimates made during previous reviews and now quantified more precisely via data gathered by ASIC upon which this review has relied.

Related entities: We recommend refining the definition of related entities as that term is used in the definition so that it explicitly recognises unincorporated legal entities such as joint ventures, partnerships and trust structures and treats all businesses that are under common control as a single group. Considerable care is required in developing the precise wording to be used in order to avoid unintended consequences and to ensure that it can readily be applied in practice by banks. While we provide the rationale for these recommendations, legal advice beyond our scope would be required in order to reach a definitive recommendation.

Implementation: We recommend that the more significant changes identified, including the need to refine the definition of related entities, are implemented at the same time as any other changes that arise from the broader review of the Code in 2021. This will help to minimise the

⁵ The ABA's submission opposed increasing the credit exposure criterion to A\$5m as "it appropriately reflects the policy intent behind the Code of ensuring small businesses have the benefits of protections while leaving larger, more sophisticated businesses free to negotiate appropriate conditions with their bank."

cost and risk to banks and other stakeholders of these changes. Thereafter, reflecting the significant evolution of the Code over recent years, we recommend that further changes should be as limited as possible for a period of at least three to five years.

More broadly, we have considered carefully, and our recommendations are informed by, the current economic circumstances in Australia brought about by the COVID-19 crisis and subsequent recession. Many small businesses currently face significant challenges, and these conditions are likely to continue into 2021 and potentially beyond. Unsurprisingly, many stakeholders identified the importance of these factors.

Our recommendations result from investigating the series of questions laid out in our terms of reference. For clarity, we set out below our specific answers to these questions.

Figure 4: Summary of our responses to the questions raised in our terms of reference

Focus of question	Pottinger's perspective
The overall balance of the definition	We believe the overall balance of the definition is appropriate, subject to the various refinements outlined below
The turnover threshold	Turnover is an appropriate criterion for determining small business status under the Code, and is used by several other definitions of small business
	Turnover is a necessary criterion, ensuring that businesses with high revenues but low borrowing requirements and employee numbers are not inappropriately categorised as small businesses
	The turnover threshold of A\$10m is set at the appropriate level, ensures the large majority of businesses are captured by the definition, and is broadly consistent with both the employee numbers and aggregate borrowings criteria
The employee threshold	The number of employees is an appropriate criterion for determining small business status under the Code, and is used by many other definitions of small business
	The number of employees is a necessary criterion, ensuring businesses with a significant number of employees, low borrowing requirements and modest revenues are not inappropriately categorised as small businesses
	The employee threshold of 100 employees is set at the appropriate level, ensures the large majority of businesses are captured by the definition, and is broadly consistent with both the revenue and aggregate borrowings criteria
Application of the definitions at a group level	The revenue and employee numbers criteria should be applied at a group level
	A new definition is required, in order to ensure entities such as partnerships and unincorporated joint ventures are taken into account and to avoid exclusion of businesses that are related entities but are neither under common control nor operate as single economic entities
The credit criterion	The credit criterion should continue to be applied to the 'total credit exposure' of the borrower and its related entities (based on a new definition) and should not be applied on a per facility basis
The credit threshold	The credit threshold should apply to aggregate borrowings and should be increased in due course to A\$5m, in line with the recommendations of previous reviews
Inadvertent implications of the definition	The definition of related entities results in it unintentionally and inappropriately excluding some types of business, such as businesses that are not under common control, but which are owned by members of an extended family
	The definition of related entities results in it unintentionally and inappropriately including as a small business some larger economic entities that operate through unincorporated joint ventures, partnerships and other similar structures
	The changes we propose should be endorsed by the ABA in the near term, with implementation of certain changes to commence at the next convenient juncture

Focus of question	Pottinger's perspective
Timing of proposed changes	(eg early to mid-2021). The remaining changes – those which require further assessment (including eg legal analysis) – should be implemented following completion of the broader review of the Code that is to be carried out in 2021
	In each case, significant notice should be provided to banks to help minimise the cost and risk of implementing such changes
	We do not anticipate any material impact on small businesses of this approach

The terms of reference for our review also required us to consider the potential benefit to customers of any change in the definition of small business used by the Code, as well as any effect on the availability or price of credit to business customers as well as on competition in the banking sector. We comment briefly on these questions below.

- **Benefits to customers:** Increasing the aggregate borrowings limit from A\$3m to A\$5m would give around 10,000 business customers access to the protections of the Code. These businesses are likely to be significantly larger than the average small business that is protected under the Code. For example, their average borrowings are estimated to be around A\$3.6m to A\$3.8m based on data provided to us by ASIC. We anticipate that these businesses will thus have proportionately more turnover and employees, and as a result are more significant enterprises in terms of their contribution to Australian economic output and employment. We consider this an important consideration as Australia undertakes to repair its industry, community and economy as a result of the COVID-19 crisis. The primary benefit for these customers will be increased confidence that they will be treated reasonably and fairly by their bank. Providing access to the Code's protections may give such customers greater confidence, and a more frictionless means, to take on additional borrowing, for example, as may be required to support business growth as the Australian economy emerges from the current recession;
- **Availability or price of credit:** There are several factors that could, in theory, impact on the availability or price of credit to business customers if the aggregate borrowings criterion is increased from A\$3m to A\$5m. These will primarily relate to a bank's assessment of the risk related to a proposed facility, or to its assessment of its ability to manage risks related to that facility over time, that may arise through the requirements imposed by the Code in relation to small business customers. In practice, a small number of banks identified that these potential risks might emerge, but we have not identified or been provided with any data or evidence through which we can quantify this risk. Ultimately, we note that the loans involved account for only a small portion of overall business lending in Australia. Our overall view is that any such risks can best be mitigated by ensuring appropriate notice is given to banks of proposed changes; and
- **Potential impact on competition:** We estimate that the value of loans that would fall within the scope of the Code if the borrowings limit was increased from A\$3m to A\$5m would be approximately A\$37bn. This equates to approximately 4.6% of all business lending in Australia by value, or 5.4% of all business lending by ABA members, or 5.8% of all business lending by ABA members with small business lending portfolios. In other words, the proportion of the business lending sector that would be affected by these changes is small.

Overall, as the size of the proposed changes is modest set against the context of banks' lending activities, we believe there is unlikely to be any material impact on ongoing competition in the provision of loans to small business as a result of these changes. Further detail is set out in section 2.5 (The extent and nature of companies impacted by these definitions).

Further context on our overall recommendations is set out in Section 6 (Overall observations and recommendations) of our report.

1.6 Other measures to support the Code and increase its impact

Most if not all stakeholders have identified that small businesses and other stakeholders find the many different definitions of small business currently in use in Australia to be confusing. During our review, we have identified at least 13 different definitions employed by different organisations and/or regulatory and/or legislative regimes. These use different combinations of revenue tests, employee number tests and borrowings tests, including eight which use just one measure (either revenue or employee numbers), three which use two measures, and two which use all three measures.

The various regimes are illustrated below.

Figure 5: Examples of definitions of "small business" currently in use in Australia (axes not to scale)



Figures in Australian dollars. Source: Pottinger research

One particular challenge in relation to the Code is that it is not straightforward for an enterprise to determine whether or not it qualifies under the Code, as this depends on the Code itself, as well as the definitions of related entities and certain carve-outs from the Code.

In addition, we note that some banks use more relaxed criteria to identify which enterprises should be treated as small businesses under the Code. This is beneficial to such businesses (as more benefit from the protections under the Code) but can add further to customer confusion.

Meanwhile, we have also observed that a business may be classified as a small business during one set of business dealings with a bank, but that this can change if the business grows (or the scale of its related entities grows) without the customer necessarily understanding that this has occurred.

Based on our discussions, greater confidence and transparency in whether an enterprise qualifies as a small business would be seen by many stakeholders as particularly helpful. There is, however, no practical way to consolidate the many different definitions into a single, simple test, as they are used by a wide variety of bodies for quite different purposes.

Measure 1: A national 'small business' labelling scheme should be introduced

An interested stakeholder or group of stakeholders could establish a nationally recognised and trademarked image to indicate that an enterprise qualified for small business protections or

benefits in their dealing with the organisation in question. Relevant organisations could license this mark to use on their contracts, statements and other communications with consumers.

This approach would enable consumers to understand their protected status easily, without having to apply the relevant tests themselves, thus providing greater confidence and transparency. With collaboration from other relevant bodies, this “P” mark could be extended to other applications, irrespective of the precise set of criteria that was used by the organisation in question to determine eligibility for small business protections and benefits.

Data on small businesses gathered by ABS and ASIC

Many stakeholders raised the issue that it is not possible to quantify the number of legal entities (let alone groups of companies) that qualify to be treated as small businesses under the Code, or indeed under some of the other definitions in use.

In this context, we note that several definitions refer to businesses that employ fewer than 100 people, including the Code as well as those used by:

- AFCA, in determining eligibility for its small business dispute resolution process;
- ASBFEO, the Australian Small Business and Family Enterprise Ombudsman;
- ASIC, in determining whether a company is exempt from preparing and lodging a financial report and having its accounts audited⁶; and
- COBA, for the Customer-owned Banking Association code of conduct.

Measure 2: ABS should provide data on businesses with between 20 and 99 employees

Currently, the ABS presents data on several categories of business, including those that employ between 20 and 199 people. We observe that it would thus be helpful if the ABS was able to present data on small businesses that differentiates between businesses that employ 20 to 99 people and those that employ 100 to 199 people.

Measure 3: ASIC should continue to collect data on small business lending by ABA members

In relation to the Code, it is also not possible to tell from publicly available data the impact of the application of the three criteria collectively, nor the potential impact of any change in the aggregate borrowing criterion from A\$3m to A\$5m. To support this review, over the last 18 months ASIC has gathered data from relevant members of the ABA that enable precise quantification in this area. This data has been exceptionally helpful in enabling Pottinger to quantify more precisely the impact of proposed changes to the definition of small business used by the Code.

We believe it would be helpful for ASIC to continue to gather this data pending implementation of our recommendation that the borrowing criterion be increased from A\$3m to A\$5m.

1.7 A note of appreciation

In concluding, we would like to acknowledge the various government bodies, financial institutions, companies, representative bodies, consumer advocates, small businesses and individuals who contributed to our review. Every conversation, submission and survey response has provided useful information and perspective and has contributed to our findings. We greatly appreciate the time that each stakeholder has taken to provide their input.

⁶ In some circumstances, a small proprietary company may be required to lodge financial reports

2. Purpose of the review

2.1 Background to the review

The Code is the first substantive industry code to be approved by ASIC under the Corporations Act 2001, and the ABA has sought and obtained approval for all subsequent changes to the Code. ASIC's original approval of the Code was subject to the ABA agreeing to commission an independent review of the definition of small business in the Code within 18 months of the Code's commencement.

Accordingly, in September 2020, the ABA appointed Pottinger to conduct an independent review of the definition of small business under the Code.

Whilst Pottinger was appointed by the ABA and the ABA has funded the review, under the terms of our appointment, the banking industry has not had any influence over the findings and options identified by us, beyond its input as a participant in the review. Pottinger has acted independently and not in the interests of, or on behalf of, the ABA or its members.

The details of our proposed approach to the project and engagement with the ABA were set out in a project charter at the commencement of our review. Amongst other things, the project charter provided that we would not discuss issues arising from our review nor provide any draft report to the ABA whilst our review was in progress. To identify any potential factual errors in our report and to identify any areas where our findings or conclusions might not have been sufficiently clear, we provided a draft of our report to the ABA and ASIC on 16th October 2020. This report was issued in final form to the ABA and ASIC on 26th October 2020.

In undertaking the review, Pottinger has consulted ASIC on the terms of reference and ASIC has received a copy of our report at the same time as the ABA.

2.2 The Banking Code of Practice

The Code is the banking industry's code of practice. It sets standards of good banking practice for banks to follow when dealing with their individual and small business customers and their guarantors. The latest version for the Code is known as the Banking Code of Practice (2019) and a copy of this document is available from the ABA website.

The Code is applicable to individual and small business customers, as well as their guarantors. Whether or not a business is covered by the provisions of the Code is determined by reference to the definition of small business in the Code.

Currently, the Code defines a business as a small business if, at the time that it obtains the banking service in question, all of the following apply:

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

In practice, most banks focus primarily on the amount of debt outstanding to credit providers, as gathering this information is of central importance to each bank's credit assessment process. This part of the definition is expressly applied at a group level, rather than individual entity level. If a customer falls within this limit, the bank may treat the borrower as a small business customer irrespective of whether the other conditions are met. One reason for this is that data on employee numbers and annual turnover may be less readily available. In addition, as

outlined further in our report, there are other challenges in applying the turnover and employee number elements of the definition.

Customers that qualify as small businesses under the Code receive additional protections beyond those afforded by other laws and regulations, including requirements in relation to standards of care and behaviour expected of banks, transparency regarding credit decisions, and additional notice periods before banks enforce repayment⁷.

2.3 Objectives of the review

The objectives of Pottinger's review are to determine whether, and if so how, the definition of small business should be updated, taking account of our terms of reference set out below.

Figure 6: Questions to be addressed by Pottinger's independent review

1. Whether the current definition of the term in the Code adequately reflects the correct balance.
2. Whether the turnover threshold in paragraph (a) of the definition:
 - a. Is an appropriate criterion for determining small business status under the Code;
 - b. Is necessary, having regard to the extent to which it is feasible, in practice, for banks to ascertain and rely on this criterion;
 - c. Is set at the appropriate level.
3. Whether the staff threshold in paragraph (b) of the definition is:
 - a. Is an appropriate criterion for determining small business status under the Code;
 - b. Is necessary, having regard to the extent to which it is relied on in practice by banks and / or anomalies or inconsistencies resulting from applying the staff threshold;
 - c. Is set at the appropriate level.
4. Whether the criteria in paragraphs (a) and (b) of the definition should be expressly applied at a group level, and if so, how such groups should be defined (including how any term such as 'related entity' or 'related party' should be defined).
5. Whether the credit exposure threshold in paragraph (c) should:
 - a. Continue to be applied to 'total credit exposure' (TCE) – to the borrower and its related parties; or
 - b. Be applied on a 'per facility' basis.
6. Whether the threshold of A\$3 million in paragraph (c) of the definition is appropriate, and whether any other amount, including A\$5 million, would be more appropriate.
7. Whether any aspect of the definition results in it unintentionally and inappropriately including, or excluding, any class of business.
8. If any amendments are recommended, the time that such amendments should take effect, having regard to:
 - a. The prevailing economic conditions and any negative effect on the availability or price of credit for small business; and
 - b. The impact on small businesses of delaying any proposed changes.

Our scope included “the small business definition in the Code and any other provisions that the reviewer reasonably believes are necessary to inform the review”.

In addition, and without limiting the above objectives, we were directed to give specific attention to assessing and considering four specific matters, as summarised below.

⁷ There are some carve-outs in favour of the banks in relation to extended notice of enforcement action

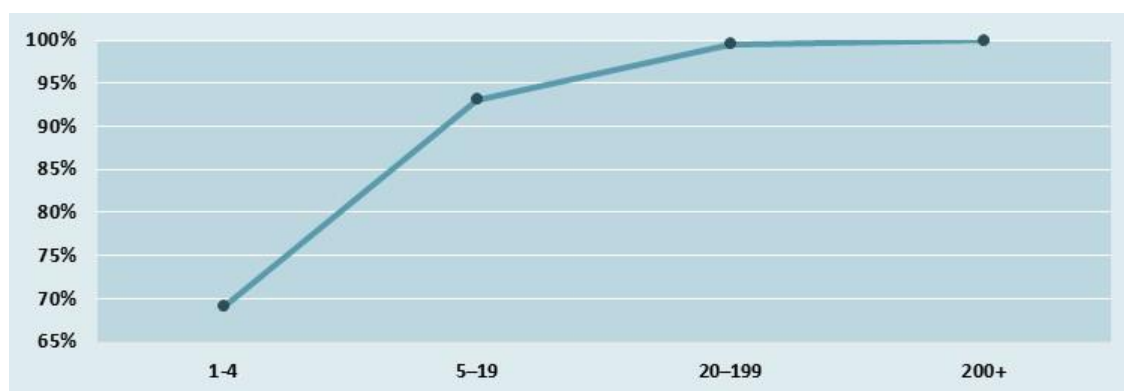
Figure 7: Specific matters to be addressed by Pottinger's Independent Review

1. Previous recommendations and observations, and the reasons given, of the Royal Commission, The Khoury Review, the ASBFEO Inquiry into Small Business Loans, the Council of Financial Regulators, as well as any industry responses to such recommendations.
2. The impact of any proposed change to the definition including:
 - a. Any anticipated benefit to business customers, having regard to any available evidence such as on disadvantages to businesses as a result of not having access to the Code terms and conditions;
 - b. Any effect (positive or negative) on the availability or price of credit to business customers;
 - c. Any effect (positive or negative) on competition in the banking sector and in particular whether it would disproportionately affect any subset of Code subscribing banks.
3. Any relevant and available data collected by the Australian Securities and Investments Commission (ASIC); the Banking Code Compliance Committee (BCCC); and the Australian Financial Complaints Authority (AFCA), that assist in assessing the above matters.
4. Any benefit that would result from alignment with other definitions of small business such as that adopted for the jurisdiction of AFCA and in ASIC's internal dispute resolution guidance, and whether the adoption of any such definition would be appropriate, having regard to the objectives of those other definitions.

The scope of our review was agreed by the ABA and ASIC.

2.4 Entities which are impacted by the definition of small business

Small businesses are critical to the Australian economy. For example, of the 884,821 businesses recorded by ASIC at June 2019 as having employees, 823,715 or 93% employed fewer than 20 employees. Only 4,271 or 0.5% employed 200 or more people.

Figure 8: Proportion of businesses with employees employing up to the number of employees stated⁸

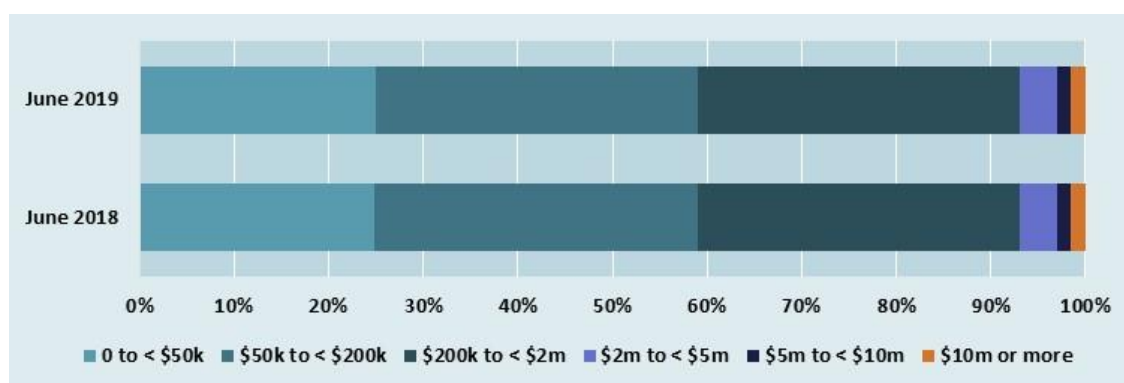
Source: Pottinger analysis of ABS data

Data is not available for the number of businesses with fewer than 100 employees, as the category reported is 20 to 199 employees. As a number of definitions use the 100-employee metric, it would be helpful if the ABS were to report an additional category (ie 20 to 99 and 100 to 199) or alternatively adjust the bands to report 20 to 99 and 100+ employees. Based on the above data, we estimate that 97% to 98% of all businesses have under 100 employees.

Meanwhile, at the same date, 98.4% of all businesses recorded had turnover less than A\$10m⁹, ie would satisfy this criterion of the definition of small business under the Code.

⁸ Source: ABS data - ABS 8165. Figures exclude companies that have no employees

⁹ Source: ABS data - ABS 8165

Figure 9: Proportion of businesses with revenues in the band indicated¹⁰

Figures in Australian dollars. Source: Pottinger analysis of ABS data

It is not possible to determine from ABS data the number of businesses that have both turnover of under A\$10m and fewer than 100 employees as the data is not presented in this manner. Even if there was no overlap between these categories, however, it is clear that at least 95% of businesses will meet both tests if these are applied on a legal entity basis.

It is also not possible to tell from ABS data how these figures would change if all businesses were judged on a consolidated basis, ie aggregating the turnover and employee numbers of related businesses. Nevertheless, we do not anticipate that this information would show a materially different distribution of businesses by scale.

There are a variety of definitions of small business in day to day use in Australia, including those employed by ASIC, the ABS, the Australian Tax office (“ATO”). These definitions use a variety of metrics and parameters, as illustrated below.

Figure 10: Definitions of small business in common use in Australia

	FTEs	Revenue	Other	Group	Basis
ABA – Banking code	<100	<A\$10m	Aggregate borrowings <A\$3m	Group	All 3
ABS – National statistics	Multiple categories	Multiple categories		Individual	N/A
AFCA – Dispute resolution	<100		Facility <A\$5m	Group	Both
APRA – SME guarantee scheme ¹¹		<A\$50m		Group	N/A
ASBFEO – Advocacy and assistance	<100	<A\$5m		Individual	1 of 2
ASIC – requirement to prepare financial statements	<100	<A\$50m	Consolidated gross assets <A\$25m	Group	2 out of 3
ATO – Tax rules		<A\$10m	Also revenue <\$2m and <\$5m	Group	N/A
COBA – Mutual banking code	<20 or <100 ¹²				

¹⁰ Source: ABS data - ABS 8165. Figures exclude companies that have no employees

¹¹ <https://treasury.gov.au/sites/default/files/2020-04/sme-guarantee-scheme-rules.pdf>

¹² The higher figure is for businesses that involve the manufacture of goods

	FTEs	Revenue	Other	Group	Basis
Fair Work Act – Reduced compliance	<15			Group	N/A

Source: Pottinger research

As a result, businesses may be categorised as 'small businesses' in relation to one or more of the above examples (such as the ATO or for Fair Work Act purposes) but will not be treated as small businesses under the Code. Almost all stakeholders have reported that this results in confusion regarding the protections available to such customers as well as the avenues through which they may be able to seek redress¹³.

Meanwhile, the definition of small business under the Code refers to related entities as defined in the Corporations Act 2001. This can result in the exclusion of some small enterprises from the protection of the Code as they are aggregated for the purpose of the aggregate borrowings criterion with other enterprises that in practice operate independently. One example is small farming enterprises that are managed as stand-alone entities by members of the same family.

On the other hand, the definition of related entities does not address certain types of unincorporated business and as a result large and sophisticated enterprises that operate through such structures may inadvertently be protected by the Code.

To address the uncertainty that these issues may create, each bank that complies with the Code may implement policies and practices, and these may vary from institution to institution. This creates an additional source of uncertainty for small business customers.

As a matter of business practice, a bank that subscribes to the Code may or may not advise a given customer as to whether or not they are being treated as a small business. If a customer is so advised by the bank in question, then under relevant Australian law they will be able to rely on this in their dealings with the bank, at least until such a time as a change in the customer's circumstances could trigger a change in classification.

If a customer is not advised of their status, then to determine their eligibility for protection, the customer would need to:

- Review the provisions of the Code currently in force;
- Consider the implications of the definition of related entities set out in Section 9 of the Corporations Act 2001; and
- Consider whether any of the exemptions in the Code apply, including those that derive from Australia's financial services regulatory regime.

We note that small businesses may find it challenging to work through these issues and so may find it hard to know whether or not they can rely on the protections under the Code.

The definition of related entities can also result in some categories of business that are demonstrably sophisticated in nature and whose ability to access relevant institutional banking products may be inhibited by being classed as a small business. There is thus a case for such businesses to be automatically excluded from the protections of the Code.

The protections afforded by the Code are only directly relevant to customers of banks that are subscribers to the Code. Nevertheless, under paragraph 912A(1)(a) of the Corporations Act 2001, there is an obligation on all Australian Financial Services licence holders to "do all things

¹³ Source: Pottinger stakeholder consultations

necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly” and to comply with the conditions of the licence and financial services law¹⁴.

ASIC's Regulatory Guide 104 suggests that Australian financial service licence holders should "look at good industry practice as captured in standards", noting that "Industry and Australian standards are relevant to most licensees because these have been drafted with the Australian regulatory environment in mind". Accordingly, any ADI that holds an Australian financial services licence should consider whether it should comply with the provisions of the Code, irrespective of whether or not it is a member of the ABA.

These issues highlight the importance of any definitions employed being as straightforward as possible to understand and implement, to ensure ease of use and transparency.

Finally, we note that Australia's states and territories offer support for small businesses. Most states define a small business as having fewer than 20 employees, with NSW also applying a test of under A\$2m of revenue. Meanwhile, ACT and Tasmania provide support for small business but do not, as far as we are aware, define what qualifies as a small business.

Figure 11: Definitions of small business applied by the States and territories

State	NSW ¹⁵	NT ¹⁶	QLD ¹⁷	SA ¹⁸	VIC ¹⁹	WA ²⁰
FTEs	<20	<20	<20	<20	<20	<20
Revenues	<A\$2m	n/a	n/a	n/a	n/a	n/a

As with national definitions, the lack of consistency across these definitions may add to consumer confusion.

2.5 The extent and nature of companies impacted by these definitions

Currently the ABA has 22 Authorised Deposit-taking Institution (“ADI”) members, of which 19 subscribe to the Code. 17 have small business lending portfolios, as illustrated below.

Figure 12: Current members of the ABA

Small business lenders				No SME lending
AMP Bank	Bendigo and Adelaide Bank	Macquarie Bank	Suncorp	<i>Arab Bank Australia</i>
ANZ Banking Group	Citigroup	ME Bank	Westpac Bank	<i>Bank of America</i>
Bank Australia	Commonwealth	MyState Bank		<i>Bank of China</i>
Bank of Queensland	HSBC Bank	NAB		<i>MUFG Bank</i>
Bank of Sydney	ING Bank	Rabobank		<i>United Overseas Bank</i>

Source: ABA website as of 15/10/20

¹⁴ ASIC interpretations of this part of the Corporations Act 2001 are set out in RG 104 Licensing: Meeting the general obligations.

¹⁵ Small Business Commissioner (NSW), Small Business Landscape, which is available from this link

¹⁶ Department of Trade, Business, and Innovation (NT), NT Business Count, Report (2018), which is available from this link

¹⁷ Department of Employment, Small Business and Training (Qld), Queensland and Small Business Strategy, Discussion Paper (2019), which is available from this link

¹⁸ Department for Innovation and Skills (SA), Small Business, which is available from this link

¹⁹ Business Victoria, Small Business in Victoria - By the Numbers, (2019), which is available from this link

²⁰ Small Business Development Council (WA), Small Business in Western Australia, (2019), which is available from this link

At 31st August 2020, the most recent date for which statistics have been provided by APRA, collectively these banks represent approximately 89% of the assets in the Australian banking system, approximately 85% of outstanding loans to non-financial businesses, and approximately 94% of deposits received from non-financial businesses²¹, as illustrated below.

Figure 13: Proportion of the Australian banking system covered by the Code



Source: Pottinger analysis of APRA data at 31st August 2020

The market share of ABA member banks remains stable from quarter to quarter, as illustrated by the chart below which shows share of business lending by quarter since 31st December 2019.

Figure 14: Proportion of Australian business lending by ADIs covered by the Code



Source: Pottinger analysis of APRA data since 31st December 2019

Approximately three quarters of business lending by ADIs which do not subscribe to the Code is carried out by fifteen large global banks. We note that these banks focus primarily or entirely on lending to larger businesses.

We note that several banks, namely Citibank, HSBC, ING and Rabobank, have one entity (an Australian company that is an ADI) that subscribes to the Code and a second (a branch of an offshore banking entity) that does not. The customers of the Australian entities will thus be protected by the Code (assuming they are small businesses), whereas customers of the offshore banking entity may not benefit from these protections. In practice, given the nature of these businesses, we anticipate that very few if any of the latter customers would qualify as small businesses in any event.

²¹ Source: Pottinger analysis of APRA data, which is available from this link

Data collected by ASIC

One challenge faced by previous reviews has been the lack of precise data on how the three criteria used by the Code interact. To address this issue, since 1st January 2019, ASIC has collected quarterly data from members of the ABA on their lending to smaller businesses. This includes data from the 17 ADIs which have small business lending portfolios (relating to 19 entities in the first quarter, prior to a merger of two members, and 18 entities thereafter). Aggregate statistics based on this data have been provided to Pottinger to support our review.

This data shows that, at 30th June 2020, ABA members had approximately 1.54 million loans outstanding to entities with a total credit exposure of less than A\$3m (ie which would qualify as a small business customer under this element of the definition). At that time, the total loan amount outstanding was some A\$214bn, equivalent to roughly 32% of total business lending by ABA members (ie A\$660bn) at the same date. These figures imply an average loan size of roughly A\$140k.

These figures do not provide a precise measure of the extent of business banking relationships, for several reasons:

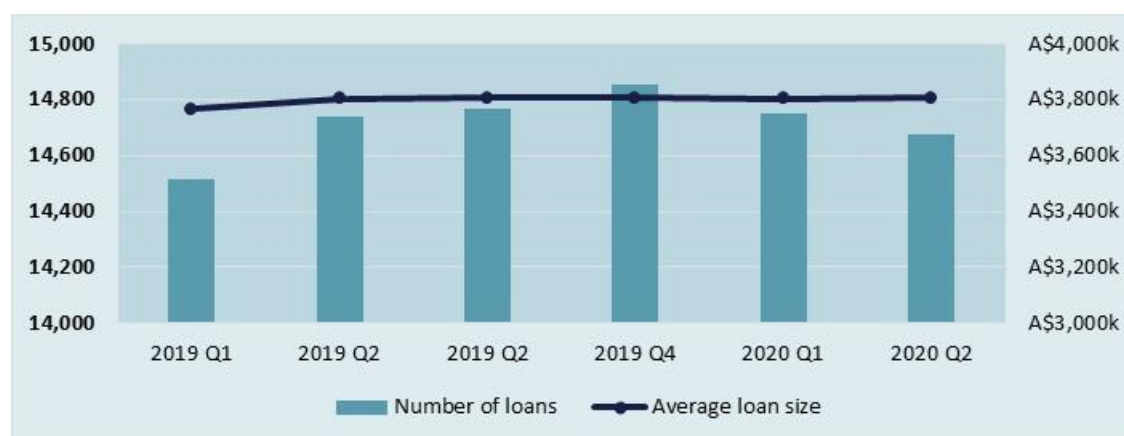
- The figures do not capture any lending to business customers by non-bank lenders;
- Some businesses may be excluded by banks through application of the turnover test and/or the employee numbers test; and
- Banks may choose to treat customers with a higher level of borrowings as a small business customer.

Nevertheless, it is reasonable to assume that the protections of the Code effectively apply to over 90% of all business banking relationships by number, and to roughly a third of all business lending by credit outstanding.

Meanwhile, as at the same date, there were approximately 1.55 million loans outstanding to entities with a total credit exposure of less than A\$5m. At that time, the total loan amount outstanding was some A\$270bn or 41% of total business lending by ABA members. The figures imply an average loan size of roughly A\$175k.

Thus, there were approximately 15,000 loans outstanding to entities with a total credit exposure of between A\$3m and A\$5m, with a total loan amount outstanding of some A\$56bn or 8% of total business lending by ABA members, with an average loan size of roughly A\$3.7m. These figures have remained fairly stable over the last 18 months, as illustrated below.

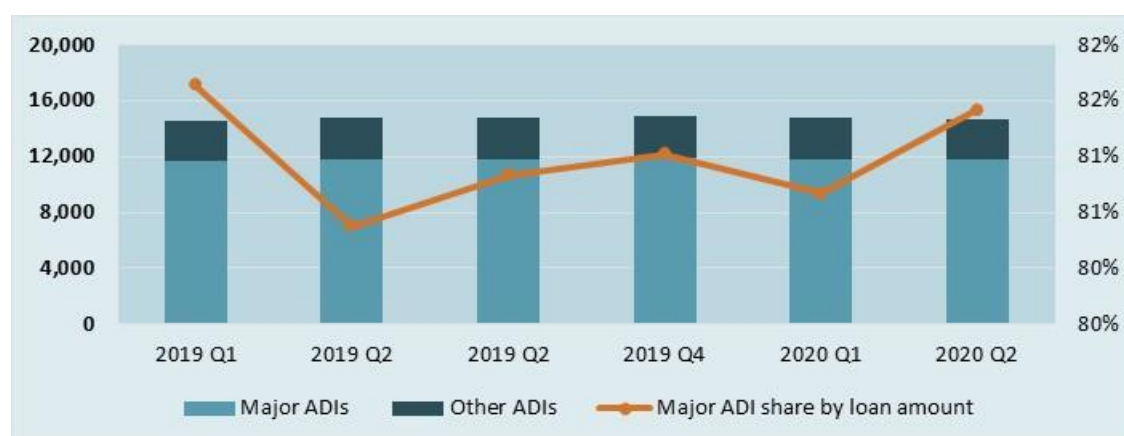
Figure 15: Number of loans with total credit exposure between A\$3m and A\$5m and average loan value



Source: Pottinger analysis of data provided by ASIC

Meanwhile, a little over 80% of these loans by value are held by major ADIs (ie the Big Four banks), as illustrated below.

Figure 16: Share of loans where total credit exposure is between A\$3m and A\$5m



Source: Pottinger analysis of data provided by ASIC

The composition by number of loans is very similar at between 80% and 82% over this period.

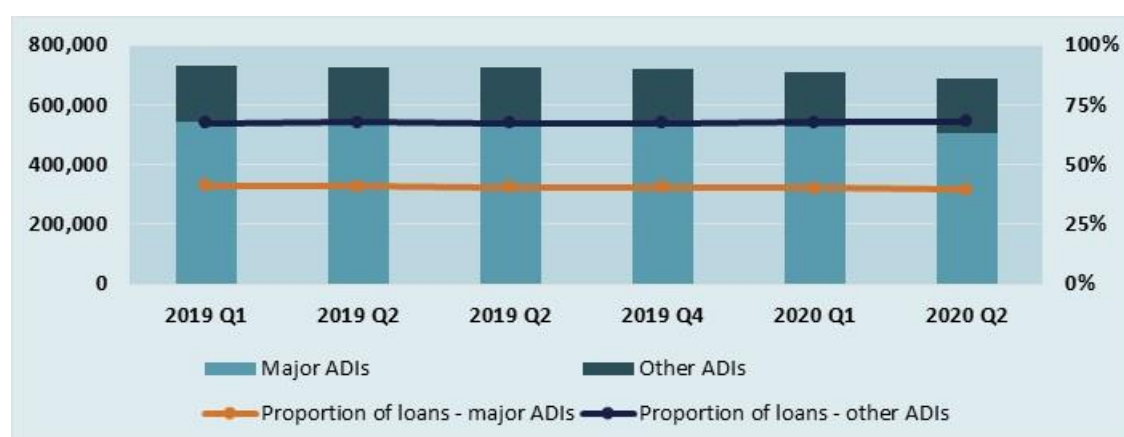
We note that the above statistics relate to individual loan facilities, ie the number of individual customers will be lower than these figures to the extent that customers have more than one facility outstanding.

Overall, these figures indicate that, if the limit of A\$3m used in the aggregate borrowings criterion was increased to A\$5m, up to around 15,000 additional businesses could qualify as small business customers under the Code. In practice, the number may be lower than this due to the application of the turnover test and/or the employee numbers test. We address the impact of application of the turnover test further below.

Impact of the revenue criterion

The data provided to Pottinger by ASIC also helps to quantify both the number of businesses excluded from the protections of the Code by application of the revenue criterion in conjunction with the aggregate borrowings criterion, as well as the prospective impact of increasing the value used by the aggregate borrowings from A\$3m to A\$5m. Only 13 of the 17 banks reporting data to ASIC were able to provide information that takes account of the revenue of the companies to which loans are made. These banks account for approximately 40% by value and 45% by number of all loans where the total credit exposure is below A\$5m, as illustrated below.

Figure 17: Number of loans where data on turnover of borrowers is available (13 banks)

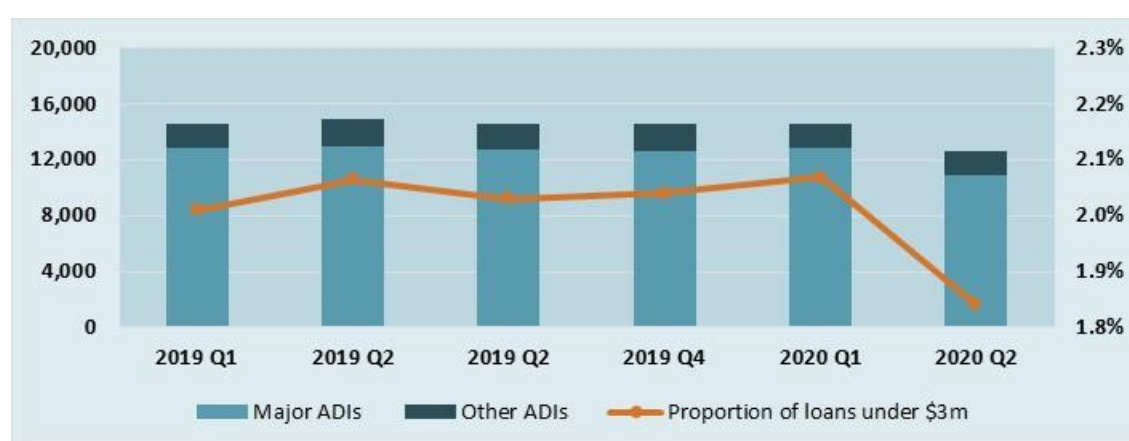


Source: Pottinger analysis of data provided by ASIC

It is important to note that the banks reporting the data above account for 40% by number of loans by major ADIs and 68% by number of loans by other ADIs, and the data that follows should be interpreted with this in mind. We set out further findings below.

For these 13 banks, as at 30th June 2020, approximately 12,500 loans were to companies with total credit exposure below A\$3m and revenue above A\$10m. This compares to approximately 672,000 loans to companies with total credit exposure below A\$3m and revenue below A\$10m. This indicates that approximately 2% of companies with total credit exposure of below \$3m are excluded from the protections of the Code by application of the turnover criterion. We note that the average size of loans provided by the 13 banks for which data is available (A\$151k at 30th June 2020) is moderately lower than the average size of loans provided by all 19 banks (A\$174k at 30th June 2020), so it is possible that the above figure of 2% may underestimate the impact of the turnover test slightly.

Figure 18: Number and proportion of businesses excluded by application of the turnover test (13 banks)

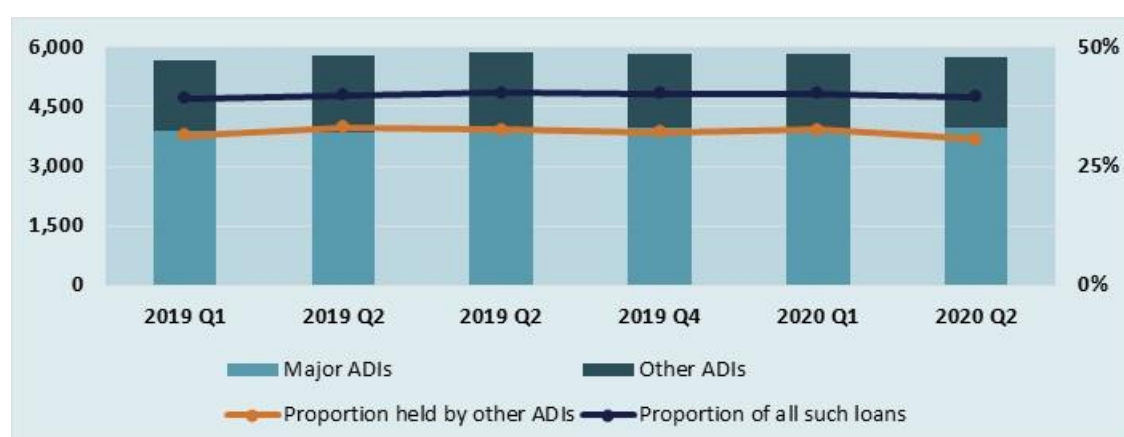


Source: Pottinger analysis of data provided by ASIC

We note that, having remained fairly steady over the preceding five quarters, the number of such loans fell approximately 15% between 31st March 2020 and 30th June 2020, presumably as a result of the impact of the economic downturn on business revenues.

The data from ASIC shows that at 30th June 2020 there were approximately 5,750 loans by these 13 banks to customers with total credit exposure between A\$3m and A\$5m. Of these, approximately one third were accounted for by other ADIs. These figures have remained fairly stable over the last six quarters, as illustrated below.

Figure 19: Number of loans to customers with total credit exposure between A\$3m and A\$5m (13 banks)



Source: Pottinger analysis of data provided by ASIC

As noted above, this data set is for 13 of the 19 banks. We note that the above figures account for approximately 40% of all such loans by the 19 banks, very similar to the proportion of customers and loans that the 13 banks represent, so should thus be representative of all banks.

However, approximately one third of customers with total credit exposure between A\$3m and A\$5m have turnover of A\$10m or more and so would be excluded as a small business by application of the turnover criterion. Thus, as illustrated below, at 30th June 2020 approximately 4,000 customers of the 13 banks would have qualified as small businesses if the aggregate borrowing criterion was increased from A\$3m to A\$5m.

Figure 20: Number of additional enterprises that would qualify as small business customers (13 banks)

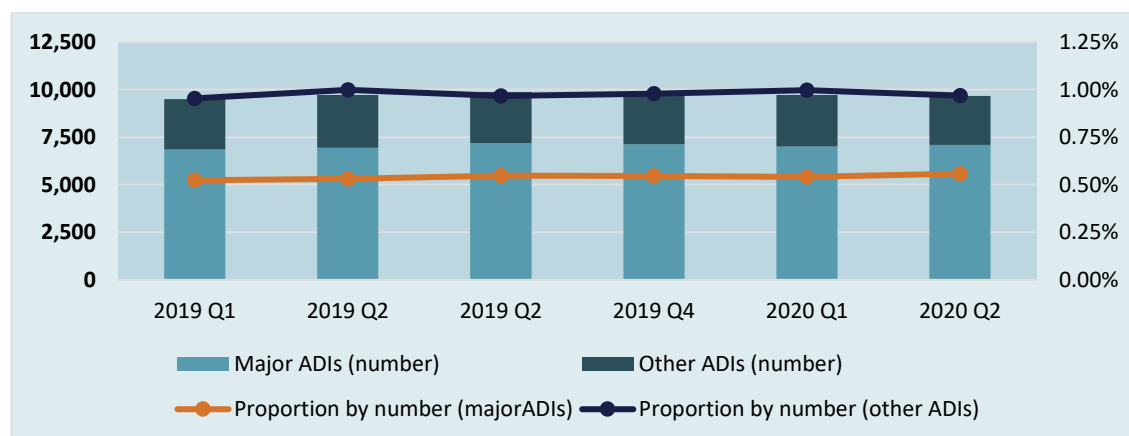


Source: Pottinger analysis of data provided by ASIC

This data relates to 13 of the ABA's member banks. These 13 collectively represent roughly 40% of all small business lending. We have assumed the proportion of loans impacted would be the same across all banks in the two categories for which we have data (ie for major ADIs and for other ADIs respectively).

On this basis, we estimate that for all ABA members, approximately 9,700 additional enterprises would be classified as small businesses if the aggregate borrowings criterion was increased from A\$3m to A\$5m. As at 30th June, these loans represented approximately 0.6% (major ADIs) and 1.0% (other ADIs) of the number of loans to enterprises with total credit exposure below A\$3m. These numbers and ratios have remained reasonably stable over the last six quarters, as illustrated below.

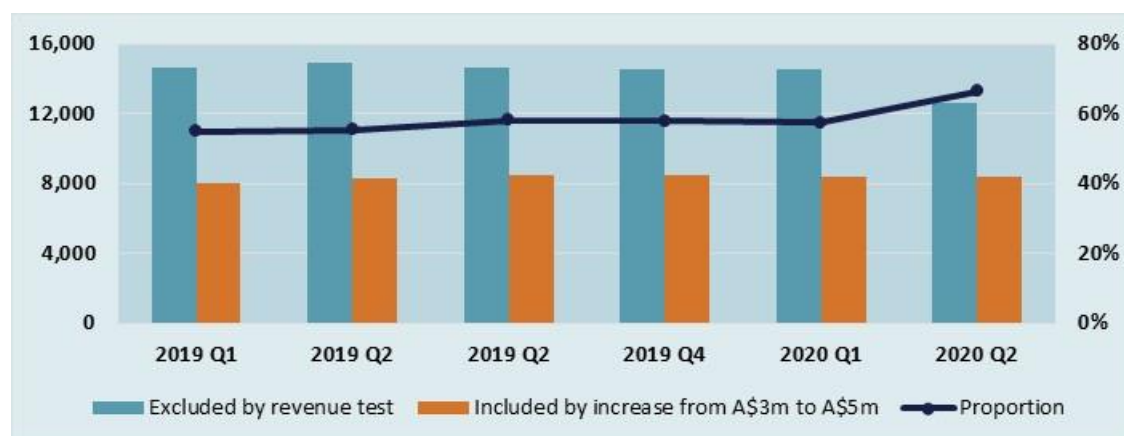
Figure 21: Impact of increasing the aggregate borrowings limit from A\$3m to A\$5m (all ABA members)



Source: Pottinger analysis of data provided by ASIC

Finally, we observe that for the 13 banks, the number of loans that would be included as a small business if the aggregate borrowings limit was increased from A\$3m to A\$5m is approximately two-thirds of the number that are excluded by application of the A\$10m revenue limit, as illustrated below.

Figure 22: Comparison of impact of revenue test with increase in borrowings limit (13 banks)



Source: Pottinger analysis of data provided by ASIC

Overall, this data indicates that:

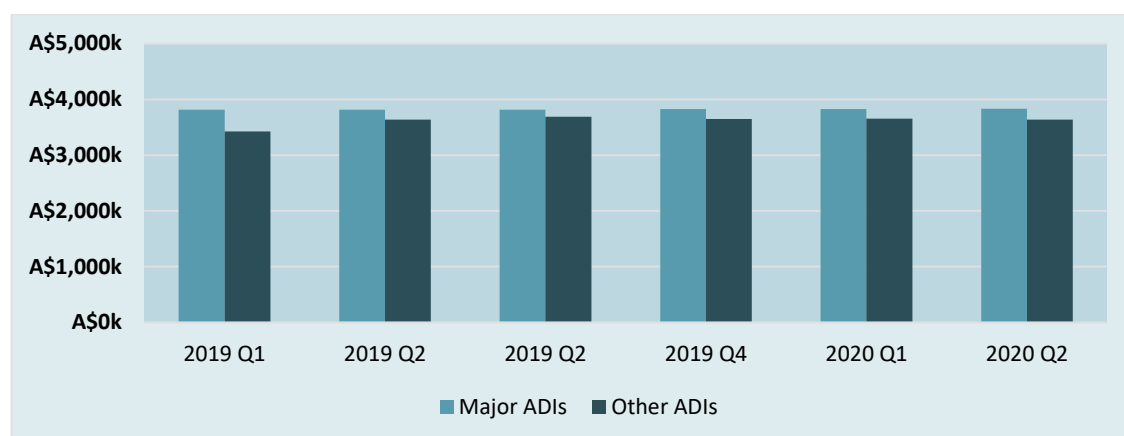
- Increasing the borrowings criterion from A\$3m to A\$5m would give approximately 9,700 additional enterprises protection under the Code;
- This represents approximately 0.6% (major ADIs) and 1.0% (other ADIs) of the number of loans to enterprises with total credit exposure below A\$3m and revenue below A\$10m; and
- This is comparable in magnitude to the number of loans excluded by application of the revenue test.

Judged by the number of facilities that might be effected, the impact of such a change should therefore have only a modest effect on banks, so long as it is implemented in a manner that minimises the costs and any potential disruption caused by the implementation process itself. We note that a number of other issues have, however, been raised as a result of our stakeholder consultation process and address those later in this report.

Potential benefits for business customers

Increasing the aggregate borrowings limit from A\$3m to A\$5m would give around 10,000 business customers access to the protections of the Code. These businesses are likely to be significantly larger than the average small business that is protected under the Code. For example, their average borrowings are estimated to be around A\$3.6m to A\$3.8m, a little more than 20 times the size of the average loan to a small business of c. A\$175k reported in the data provided by ASIC. The chart below indicates the estimated average loan size for these customers at major ADIs and other ADIs.

Figure 23: Estimation of average size of loans included by increasing the borrowings test to A\$5m



Source: Pottinger analysis of data provided by ASIC

We anticipate that these businesses will thus have proportionately more turnover and employees, and as a result are more significant enterprises in terms of their contribution to Australian economic output and employment. We consider this an important consideration as Australia seeks to repair its industry, community and economy following the COVID-19 crisis.

Ultimately, the primary benefit for these customers will be increased confidence that they will be treated reasonably and fairly by their bank. Providing access to the Code's protections may give such customers greater confidence, and a more frictionless means, to take on additional borrowing, for example, as may be required to support business growth as the Australian economy emerges from the current recession.

Potential impact on the availability or price of credit to business customers

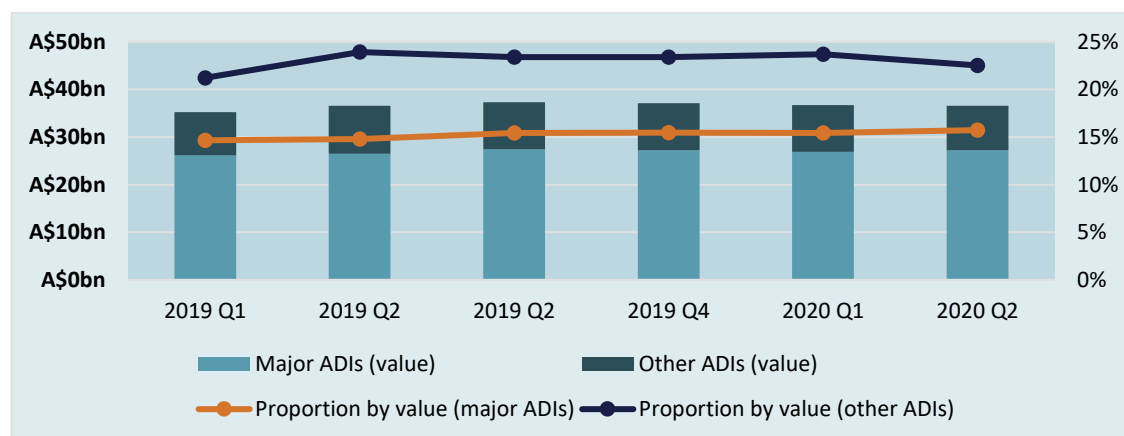
There are several factors that could, in theory, impact on the availability or price of credit to business customers if the aggregate borrowings criterion is increased from A\$3m to A\$5m. These will primarily relate to a bank's assessment of the risk related to a proposed facility, or to its assessment of its ability to manage risks related to that facility over time, that may arise through the requirements imposed by the Code in relation to small business customers.

A temporary effect caused by such factors could occur if the proposed change was implemented at relatively short notice, causing a spike in the number of business lending facilities that needed to be redocumented as a result of the new definition. The risk of this occurring should be mitigated by ensuring suitable notice is given to banks of the proposed change and by allowing a transition period during which changes could be made to facility documentation. While one mid-sized bank did speculate that increasing the borrowing criterion could have an impact on the pricing of loans, we have not identified any evidence as to whether this would occur (ie through the application of a risk-based pricing approach) or through banks stating or intimating that they would not underwrite the loans in question.

A permanent effect would occur if banks concluded that loan pricing should be increased to compensate for the risks involved and/or decided to cease writing loans in this segment of the market.

For major ADIs, the credit exposure involved represents approximately 15% of the value of all loans where the aggregate credit exposure is below A\$3m, and for other ADIs this proportion is around 23%, as illustrated below.

Figure 24: Estimation of value of loans included by increasing the borrowings test from A\$3m to A\$5m



Source: Pottinger analysis of data provided by ASIC

These figures illustrate that, whilst the impact of this proposed change is modest set against the context of total business lending, it represents a meaningful expansion in the portfolios classified as small business lending under the Code.

As we explore further later in this report, a small number of banks identified the potential risk of the factors we outline above emerging, but we have not identified or been provided with any data or evidence through which we can quantify this risk. Ultimately, we note that the loans involved account for only a small portion of overall business lending in Australia. Our overall view is that any such risks can best be mitigated by ensuring appropriate notice is given to banks of proposed changes.

Potential impact on competition

We have also considered the potential impact of these changes on the competitive landscape for small business lending in Australia.

First, we estimate that the value of loans that would fall within the scope of the Code if the borrowings limit was increased from A\$3m to A\$5m would be approximately A\$37bn.

As at 30th June 2020, total business lending in Australia was approximately A\$806bn, based on APRA's monthly banking statistics²². The potential impact of increasing the aggregate borrowings criterion from A\$3m to A\$5m thus equates to approximately 4.6% of all business lending in Australia by value. Meanwhile, the 22 ABA members had aggregate loans outstanding to business customers (including small business customers) of A\$684bn at that date. The potential impact of increasing the aggregate borrowings criterion from A\$3m to A\$5m thus equates to approximately 5.4% of all business lending by ABA members. In other words, the proportion of the business lending sector that would be affected by these changes is small.

²² Available from <https://www.apra.gov.au/monthly-authorised-deposit-taking-institution-statistics>

At the same date, the 17 banks with small business loan portfolios had total loans outstanding to small business customers of A\$640bn, representing 25% of their total lending at that date of A\$2,528bn. The impact of increasing the aggregate borrowing criteria is thus equivalent to 5.8% of their combined business lending books and 1.5% of their total lending. The impact would therefore be modest in the context of their total lending books.

Overall, as the size of the proposed changes is modest set against the context of banks' lending activities, we believe there is unlikely to be any material impact on ongoing competition in the provision of loans to small business as a result of these changes.

2.6 Framework for addressing the issues raised by the review and inputs to our work

Our review is designed to address the definition of small business in the Code, together with any other provisions that we found were reasonably necessary to inform our review. In undertaking our review, we have considered the issues under the following broad headings:

- The relevance of the criteria used by the definition, ie annual turnover, employee numbers and borrowings outstanding;
- The values used in the criteria, currently A\$10m for annual turnover, 100 for employee numbers and A\$3m for borrowings;
- Whether the criteria should be applied at an individual entity or group level, as well as the definitions used to determine which related entities should be taken into account in defining a group;
- Whether the criteria related to borrowings should apply solely to the facility in question or to the aggregate of all outstanding facilities; and
- The potential impact of any proposed changes to the criteria and/or the values, both in terms of overall materiality in the context of the banking systems and in relation to the practicalities of implementing any proposed changes.

In examining these issues, we have considered:

- The findings from our own desktop research and analysis, including data collected by ABS, APRA and ASIC (section 3);
- Previous recommendations and observations on relevant matters of the Royal Commission, The Khoury Review, the ASBFEO Inquiry into Small Business Loans, the Council of Financial Regulators, and any industry responses to such recommendations (section 4); and
- The findings from a stakeholder engagement exercise, as outlined further below, as well as data gathered from the public via a stakeholder questionnaire (section 5).

In preparing our report, in section 6.10 we have also considered the real-world impact of any proposed changes to the definitions, including:

- Any anticipated benefit to business customers, having regard to any available evidence such as on disadvantages to businesses as a result of not having access to the Code terms and conditions;
- Any effect (positive or negative) on the availability or price of credit to business customers; and
- Any effect (positive or negative) on competition in the banking sector and in particular whether it would disproportionately affect any subset of Code-subscribing banks.

We have also addressed whether there is any benefit that would result from alignment with other definitions of small business such as that adopted for the jurisdiction of AFCA and in ASIC's internal dispute resolution guidance, and whether the adoption of any such definition would be appropriate, having regard to the objectives of those other definitions.

2.7 Our approach to stakeholder engagement

We have sought input to our review from a range of sources, including:

- All members of the ABA;
- Several ADIs that are not members of the ABA as well as other non-bank financial institutions;
- Consumer and small business organisations;
- Relevant regulatory bodies;
- Various other stakeholders; and
- Small businesses, via engagement with accounting firms and the public questionnaire.

To facilitate these discussions, as part of our stakeholder engagement we hosted forums that brought together banks of a similar size and nature. All participants were also offered the opportunity for one-on-one discussions. A full list of entities consulted and how they were grouped for the stakeholder forums is set out below.

Figure 25: List of stakeholders consulted directly

Group	Stakeholders
ABA members	AMP Bank, ANZ, Bank Australia, Bank of America, Bank of Queensland, Bank of Sydney, Bendigo and Adelaide Bank, Commonwealth Bank, HSBC, Macquarie, MyState Bank, NAB, Rabobank, Suncorp, Westpac
Non-member ADIs	Auswide Bank, CUA, Judo, PayPal, RACQ Bank, Tyro
Consumer and small business organisations	Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Consumers' Federation of Australia, Council of Small Business Organisations Australia (COSBOA), Financial Counselling Australia, Consumer Action Law Centre, Legal Aid Queensland, Small Business Association of Australia
Regulatory bodies	Australia Government Department of Treasury, The Banking Code Compliance Committee (BCCC), Council of Financial Regulators, Reserve Bank of Australia (RBA)
Other stakeholders	Australian Financial Complaints Authority (AFCA), Customer-Owned Banking Association (COBA), Eftpos, South East Community Links
Accounting firms	Hassos & Associates, Wilson CA

Source: Pottinger

In addition to the organisations set out above, a number of other organisations were invited to contribute to the review and either declined or did not respond to our invitation. These organisations were primarily either ABA members or other ADIs.

In addition, to provide an opportunity for any other interested stakeholders to contribute their views, we made a questionnaire available to the general public, promoting this with the support of some of the above stakeholders, our own networks and social media.

3. Desktop research and analysis

3.1 Overview of the definition of small business

The Code sets out the standards of practice and service in the Australian banking industry for individual and small business customers, and their guarantors. In doing so, it provides safeguards and protections not set out in the law. As AFCA²³ states:

"The Code is owned and published by the Australian Banking Association and forms an important part of the broader financial services consumer protection framework. Banks can choose to sign up to the Code. When they do, they are promising to meet the Code's standards of good banking practice."

The Code is underpinned by a State of Guiding Principles, which lays out four areas of focus, as illustrated below.

Figure 26: The Code's Statement of Guiding Principles

Trust and confidence	<ul style="list-style-type: none"> ■ We are committed to earning and retaining the trust of our customers and the community ■ We are committed to making promises and keeping them to deliver good customer and community outcomes ■ We will comply with all laws relating to banking services ■ We will protect your privacy ■ We recognise our role in society and our impact on the wider community
Integrity	<ul style="list-style-type: none"> ■ We will act honestly and with integrity. ■ We will be fair and responsible in our dealings with you ■ We will build and sustain a culture based on strong ethical foundations
Service	<ul style="list-style-type: none"> ■ We will deliver high customer service and standards ■ We will ensure banking services are accessible, inclusive and provided to you in a fair and ethical manner ■ We will raise awareness of the basic (low, or no fee) banking products that we may offer ■ We will take a responsible approach to lending ■ We will work to help you if you are experiencing financial difficulty
Transparency and accountability	<ul style="list-style-type: none"> ■ We will communicate with you in a clear and timely manner ■ We will be accountable in our dealings with you ■ We will be transparent in our communications with you

Source: Pottinger presentation of language included in the Code

The Code sets out the standards of practice and service in the Australian banking industry for individual and small business customers, and their guarantors.

3.2 Nature and extent of businesses protected by the Code

The Code defines an entity as a small business if, at the time that it obtains the banking service in question, all of the following apply:

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

²³ Australian Financial Complaints Authority

It is not possible to establish from either ABS data or the information gathered by ASIC from ABA members exactly how many businesses would be categorised as small businesses under the Code if these definitions were applied. We do know from this data, however, that:

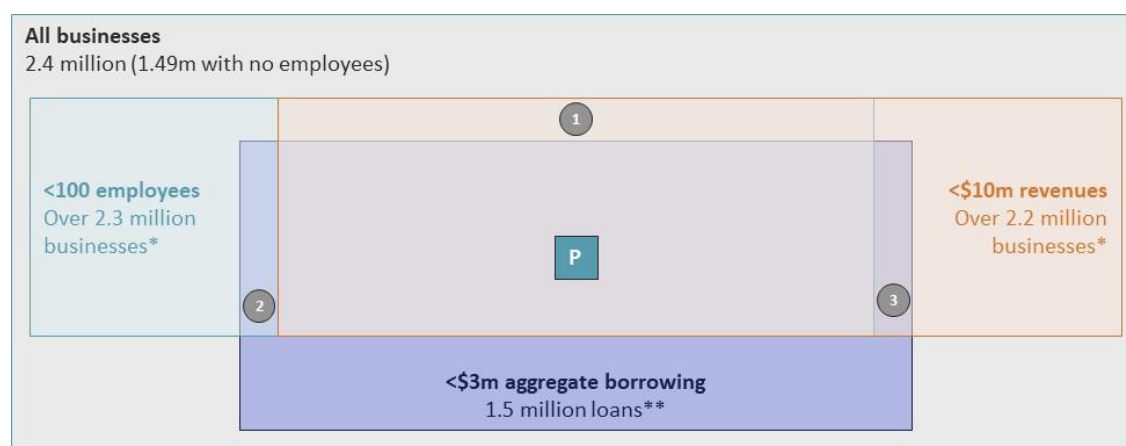
- 98.4% of businesses have a turnover of under A\$10m; and
- Approximately 97% to 98% of businesses employ fewer than 100 employees.

Thus, even if there was no overlap between these categories, over 95% of all businesses would be classified as small businesses before the aggregate borrowings criterion was applied.

These statistics also highlight the significant importance of the small business sector to the Australian economy as a whole. Overall, small businesses account for 35% of Australia's gross domestic profit and employ 44% of Australia's workforce²⁴.

In considering the application of the Code's definitions, we have reflected on the size and nature of businesses that meet the various criteria, as well as those that may be excluded because they fail to meet at least one of the criteria, as illustrated below.

Figure 27: Overview of the scope of the Code (not to scale)



Source: Pottinger presentation of ASIC data

As noted above, at least 95% of all business must fall within the employee and revenue criteria.

Companies that meet all three of the criteria are protected under the Code, as marked with a P above. As set out in the previous section, at 30th June 2020, ABA members had approximately 1.5 million loans outstanding to businesses where the total credit exposure was below A\$3m (some of which could be excluded from protection by the turnover criterion or employee numbers criterion).

Conceptually, there are three types of company that would be excluded as a result of failing to meet just one of the criteria, as illustrated by the numbers on the diagram above. These are:

- 1: Those businesses with more than A\$3m in aggregate borrowings – these might be asset intensive companies with high borrowing requirements and/or relatively profitable businesses, which in either case have less than A\$10m of revenue and fewer than 100 employees. Data provided by ASIC shows that, at 30th June 2020, ABA members had approximately 15,000 loans outstanding to enterprises with an aggregate borrowing requirement of between \$3m and A\$5m. In some cases, the nature of borrowing may mean that banks wish to use more complex documentation;

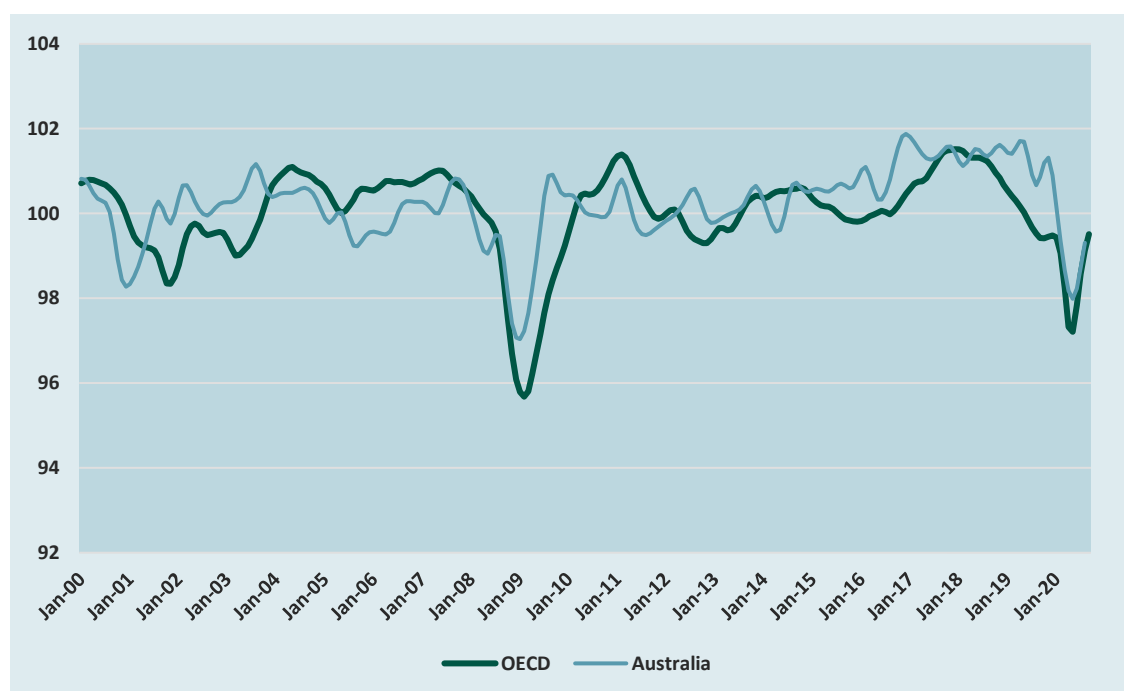
²⁴ Source: ASBFEO Small Business Counts 2019 available from this link

- 2: Those that have revenues over A\$10m. Based on the data provided by ASIC, we estimate that approximately 2% of loans by ABA members to enterprises with aggregate borrowings of below A\$3m would be excluded by application of the turnover test. These may be low margin companies that generate relatively little profit and hence cannot support much debt and/or companies that are asset light and/or have low borrowing requirements;
- 3: Those that have more than 100 employees – these will be employment intensive companies which nevertheless have modest revenues and relatively low borrowing requirements.

The main category of businesses raised by stakeholders as failing to qualify for the protections available under the Code was agricultural businesses. These exclusions often arise because businesses that are independently owned and managed by members of the same family are treated as a single group under the current definitions. Meanwhile, business relationships represented by trusts, partnerships and unincorporated joint ventures may not be captured.

In conducting our review, we have been mindful of the economic and other challenges that Australia currently faces, including the first recession in nearly thirty years, a significant increase in unemployment, and a material reduction in business confidence, as illustrated below.

Figure 28: OECD Monthly Business Confidence Survey²⁵ – year 2000 to date



Source: Pottinger presentation of OECD data

Looking ahead, numerous stakeholders have commented that the small business sector will need access to debt capital to support them through the current period of weakness, and/or to enable subsequent rebuilding. Accordingly, we note that the number of small businesses that would be excluded from the Code by the A\$3m aggregate borrowing criterion may increase more rapidly than would otherwise be the case over the near to medium term. These circumstances thus suggest that there may now be a greater benefit of increasing the aggregate borrowing limit than was the case at the time of the Khoury Review or Hayne Royal Commission.

²⁵ Business confidence index from the OECD, source available from this link

As several stakeholders have observed, confidence in the fairness and trustworthiness of the banking system is one element of providing small business customers with the confidence to take on the additional borrowing they may require to support their businesses through the current recession and/or to rebuild capacity as the Australian economy returns to growth.

3.3 Extent of application of the Code

Subscription to the Code is voluntary, although it is a condition of ABA membership that member banks with a retail presence in Australia are required to be a signatory to the Code. Currently, the Code has 22 ADI signatories, which collectively represent some 82% of business lending by ADIs. We provide data on the size of ABA members as at 31st August 2020 below.

Figure 29: List of ABA members by total assets at 31st August 2020

Name	Category	Total assets \$bn	Lending \$bn	Business lending \$bn	% business	Business deposits \$bn
NAB	Big four banks	783.0	475.5	171.6	36%	127.9
CBA	Big four banks	970.7	651.3	135.1	21%	140.1
Westpac	Big four banks	912.2	589.5	128.5	22%	130.9
ANZ	Big four banks	685.1	405.4	117.0	29%	114.1
Bank of China	Second tier	27.5	20.5	18.7	92%	12.3
Rabobank	Second tier	19.5	17.2	16.8	98%	3.0
Bendigo & Adelaide	Second tier	90.1	64.6	14.6	23%	18.3
MUFG Bank	Second tier	30.3	19.2	13.3	69%	11.7
Suncorp	Second tier	77.2	57.3	12.3	22%	6.7
ING	Second tier	88.0	64.1	12.0	19%	3.0
Bank of Queensland	Second tier	65.4	41.5	11.3	27%	11.2
Macquarie Bank	Others	138.1	65.0	9.0	14%	27.7
UOB	Others	15.0	7.9	7.0	88%	0.1
Bank of America	Others	18.7	9.1	3.2	35%	2.9
HSBC	Others	53.3	25.5	2.9	11%	10.4
AMP	Others	29.5	20.6	0.9	4%	2.6
Bank of Sydney Ltd	Others	3.6	2.0	0.6	31%	0.6
Citigroup	Others	24.5	11.7	0.4	3%	1.9
Arab Bank	Others	1.1	0.7	0.3	39%	0.2
Bank Australia	Others	8.9	5.6	0.3	5%	0.4
MyState	Others	6.2	3.8	0.1	2%	0.3
Members Equity	Others	3.3	2.0	0.0	0%	3.1
		4,051	2,560	676	26%	629
	Number	Total assets	Lending	Business lending	% business	Business deposits
Big four banks	4	3,351	2,122	552	26%	513
Second tier	7	398	284	99	35%	66
Others	11	302	154	25	16%	50
	22	4,051	2,560	676	26%	629
Big four banks	18%	82.7%	82.9%	81.7%		81.5%
Second tier	32%	9.8%	11.1%	14.7%		10.5%
Others	50%	7.5%	6.0%	3.6%		8.0%
	100%	100%	100%	100%		100%
ASIC segmentation	Number	Total assets	Lending	Business lending	% business	Business deposits
Major ADI	4	3,351	2,122	552	26%	513
Other ADI	13	608	381	81	21%	89
No small business lending	5	93	57	43	74%	27
	22	4,051	2,560	676	26%	629
ABA small business lenders	17	3,958	2,503	633	25%	602

Figures in Australian dollars. Source: Pottinger analysis of APRA data

To illustrate the relative size of different types of bank, we have categorised ABA members into three groups, namely the Big Four banks, a second tier representing those with more than A\$10bn of business loans outstanding, and other banks with smaller business lending portfolios. The first two categories account for virtually all business lending and over 98% of business deposits by ABA members, as illustrated above. As summarised at the bottom of the table, five ABA members have no small business lending.

3.4 Nature of protections available to small businesses under the Code

The protections applicable to small businesses include provisions such as:

- When lending, exercising the care and skill of a diligent and prudent banker;
- When assessing whether a business can repay a loan, considering the appropriate circumstances reasonably known to the bank about the customers financial position or account conduct;
- Transparency regarding any decision not to provide credit;
- Providing three months' notice of any decision not to extend a loan (which would thus require the borrower to repay an outstanding balance in full);
- Giving 30 days' notice before requiring borrowers in default to repay the loan in full or taking enforcement proceedings²⁶;
- Acting fairly and transparently when using external property valuers, investigative accountants and insolvency practitioners;
- Complying with the ACCC's and ASIC's Debt Collection Guideline: for Collectors and Creditors, and only selling debt to a party that has agreed to comply this guideline; and
- Operating internal and external dispute resolution processes that comply with ASIC guidelines and providing information to customers on how they take complaints to AFCA.

Meanwhile, there are also several provisions that are specific to farmers, including not charging default interest during periods of drought and natural disasters.

We note that the Code does not apply to banking services which relate to financial products and financial services for the purposes of Chapter 7 of the Corporations Act 2001, if the business in question is classified as a 'wholesale client' rather than a 'retail client'. We have summarised the categories of financial products under Australia's financial services below:

Figure 30: Categories of financial product under Australia's financial services licencing regime

Cash and debt	Equities and derivatives etc		Insurance	Retirement	Other
Deposit and payment products	Securities	Derivatives	General insurance	Superannuation	Carbon credits
Government debentures, stocks or bonds	Margin lending	Foreign Exchange	Life products	Retirement savings account products	Managed investment schemes

Source: Pottinger analysis and Federal Register of Legislation²⁷

As a result of these definitions, a 'basic loan' (not a term of art or a legal term) is not a financial product under Australia's financial services regime. As a result, a small business taking such a loan from a bank cannot be excluded from the protections of the Code. Meanwhile, a loan which has any convertible, derivative or structured components, such as interest rate swaps and/or foreign currency elements is (or could be) classified as a financial product under Australia's financial services regime and accordingly a small business that qualified as a 'wholesale client' could be excluded from the protections afforded by the Code.

Meanwhile, a person is considered to be providing a financial service when they:

- provide financial product advice; or
- deal in a financial product; or
- make a market for a financial product; or

²⁶ Subject to certain exceptions allowing the bank to act with reduced or notice period

²⁷ Corporations Act 2001, available from this link here

- operate a registered scheme; or
- provide a custodial or depository service; or
- provide a crowd-funding service.

Inter-relationship with other consumer protection legislation

As noted above, basic lending is excluded from the scope of Australia's financial services legislation. Consumers (ie borrowers who are not businesses) obtain protection through the National Consumer Credit Protection Act. Meanwhile, the Australian Government has announced changes to this legislation to exclude all business lending from its scope²⁸, in order to “enable lenders to lend to small business confidently, further supporting businesses as Australia recovers from the COVID-19 pandemic.” This further emphasises the importance of the Code in providing protection to small businesses in relation to their borrowing needs.

Elements of the definition of small business

In considering whether, and if so how, the definition of small business might be updated, we have considered a series of issues separately. These are:

- The criteria used in the definition (currently turnover, employee numbers and total credit);
- The values used within the criteria (currently A\$10m, 100 employees and A\$3m);
- Whether the criteria should be applied at an individual company or group level; and
- Whether the criteria should be applied at a facility or aggregate borrows level.

In addition, reflecting various issues identified during our desktop review and the stakeholder engagement exercise, we have considered several definitional issues, including the definition of ‘related entities’ under the Corporations Act 2001.

Finally, we have also assessed the potential impact of changes in definition, both from the perspective of the number of additional businesses that would preserve or gain protection under the Code, as well as in terms of the potential impact on banks required to adapt their systems and processes to a new definition.

We address each of the above matters in the following sections below. Section 4 provides an overview of findings on relevant matters in previous reviews and section 5 sets out our findings from our stakeholder engagement discussions and public questionnaire.

²⁸ <https://budget.gov.au/2020-21/content/jobmaker.htm#twenty>

3.5 Consideration of the criteria used by the definition

There are numerous definitions currently used to define small business in Australia. This includes both different criteria and inter-conditionality (as illustrated below), as well as different values (as addressed in the following section).

Figure 31: Criteria used in the definition

Source	Revenue	Employees	Borrowings	Other	Cumulative
Fair Work Australia		✓			✓
NSW	✓	✓			✓
Other states		✓			
ABS		✓			✓
APRA	✓				
ATO	✓				✓
ASIC (Corporations Act 2001)	✓	✓		✓	
ASBFEO	✓	✓			
AFCA		✓	✓		
ABA	✓	✓	✓		✓
COBA	✓				

Source: Pottinger analysis

The variation in definitions creates confusion for small businesses, complexity for both private sector organisations and other bodies, and inhibits the collection of consistent data, as we explore further below.

Both turnover and employees are common measures that are easy for the board and management of a business to determine. Meanwhile, from a bank's perspective, total credit outstanding is a critical metric as this forms an essential input to any credit underwriting decision. In addition, borrowing exposures are monitored regularly, whereas turnover and/or employee numbers are only re-tested when customers provide updated financial information.

Overall, our view is that the criteria used by the definition, namely employee numbers, turnover, and total credit outstanding, represent a logical and reasonable set of metrics.

The Code definition requires a business to meet all three criteria, meaning that if a business exceeds any one of the criteria, it can be excluded from treatment as a small business.

In practice, in some cases, based on our stakeholder engagement discussions, we understand that some banks that subscribe to the Code use solely the consolidated borrowings criteria. Customers falling below the threshold are thus treated as small business customers. Application of the other criteria could exclude some of these customers from being treated as small business customers, but in practice this does not happen. A direct implication of this is that there are some customers who will be treated as a small business by some banks and not by others. A further implication is inconsistency in regulatory reporting on small business customers.

Meanwhile, we understand that some banks may apply different processes for assessing whether a customer should be treated as a small business customer between different divisions, reflecting different credit underwriting processes and/or other systems differences. It is therefore possible that two otherwise identical customers may be treated differently between different divisions or subsidiaries of the same financial institution.

Whatever criteria are used, it is important that it is simple for customers to understand whether or not they are being treated as a small business, and accordingly what protections may apply. As noted earlier in our report, it may not be straightforward for a small business to determine whether or not it qualifies for the protections available to small businesses under the Code.

In considering alternative ways to simplify how small businesses are defined, we considered the approaches adopted in other jurisdictions.

Figure 32: Approach to definition of small business in other jurisdictions

In the United States, the Small Business Administration defines businesses as small based on its size standards, which can be viewed at this link. Businesses are treated on a consolidated basis, ie aggregating relevant data for all "affiliates", ie other businesses which the business has the power to control, irrespective of whether this power is exercised. Size is determined by reference to 'annual receipts'²⁹ (averaged over three to five years) or employee numbers (averaged over the preceding 12 months), depending in the industry segment in which the business operates. There are over 1,000 different segments, with approximately half referencing annual receipts and half referencing turnover. with annual receipt limits varying from US\$1m to US\$41.5m and employee numbers from 100 to 1,500.

In the UK, for statistical purposes, small businesses are defined as firms with fewer than 49 employees³⁰. They make up 99.3% of all UK businesses and account for 48% of all jobs. The UK's Business Banking Code³¹ covers small businesses with a turnover of up to £1m (a little less than A\$2m) of turnover.

In Europe, small businesses are defined as enterprises with fewer than 250 employees and which have either an annual turnover not exceeding €50m or net assets not exceeding €43m³². Based on European Union figures, these enterprises represent 99% of all businesses in the EU, employ around 100 million people, and account for more than half of Europe's GDP. The EU has provided a range of financial support measures to these businesses in response to the COVID-19 crisis, acting through financial intermediaries and sub-intermediaries³³.

In New Zealand, for statistical purposes, small enterprises are defined as firms with fewer than 20 employees. They employ 29% of the New Zealand workforce and contribute over one quarter of New Zealand's GDP³⁴.

3.6 The values used in the criteria

In practice, there are substantial variations in the employment intensity (eg as measured by the number of employees per million dollars of turnover) and profitability (eg as measured by EBITDA³⁵ margin) by sector. As a result, the use of a single metric for employee numbers and revenues will be more favourable in some industries and less favourable in others.

For example, over the eleven years to June 2019 and across all industry subsectors, the number of employees per million dollars of turnover has ranged from 0.16 (17: Petroleum and coal product manufacturing) to 19.7 (87: Social assistance services). A business at the top of this range with A\$10m of turnover would employ 200 people. Conversely, such a business with 100 employees might have a turnover of around A\$5m. Thus, application of the turnover test in

²⁹ Broadly equivalent to turnover - see this link for the definition

³⁰ Business population estimates for the UK and regions: 2019 statistical release – available from this link

³¹ For further information, visit <http://www.bcsb.co.uk>

³² European Commission user guide to the SME definition – available from this link

³³ For further information, see eg the COSME programme, at this link

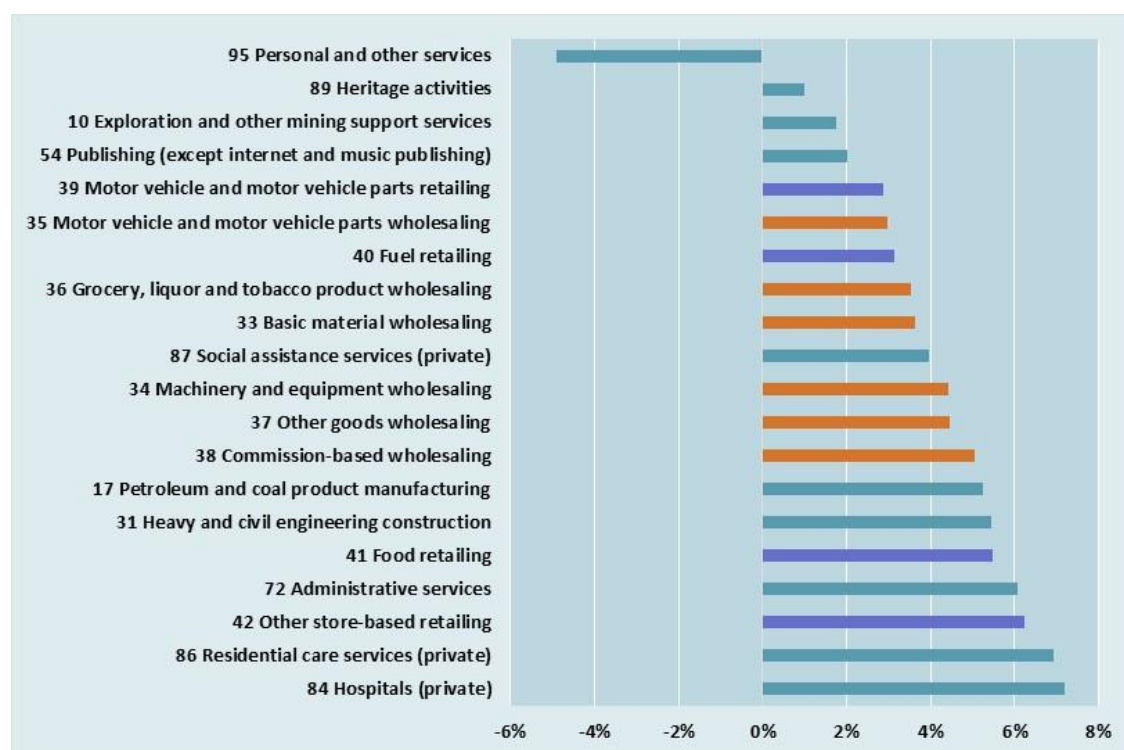
³⁴ Small business booklet 2018, available from this link

³⁵ IE the ratio of EBITDA (Earnings before interest, tax and depreciation) to turnover

conjunction with the employee number test may exclude some businesses that have relatively modest turnover but employ a relatively large number of people.

Over the same period, EBITDA margins have ranged from -8% to 70% across all industry subsectors and in the year to June 2019 ranged from -5% (95: Personal and other service) to 64% (07: Oil and gas extraction). The 20 worst performing subsectors are particularly concentrated in wholesale trade (brown) and retail trade (purple), as illustrated below.

Figure 33: Low margin businesses – bottom twenty sub-sectors in 2019 (bottom quartile)

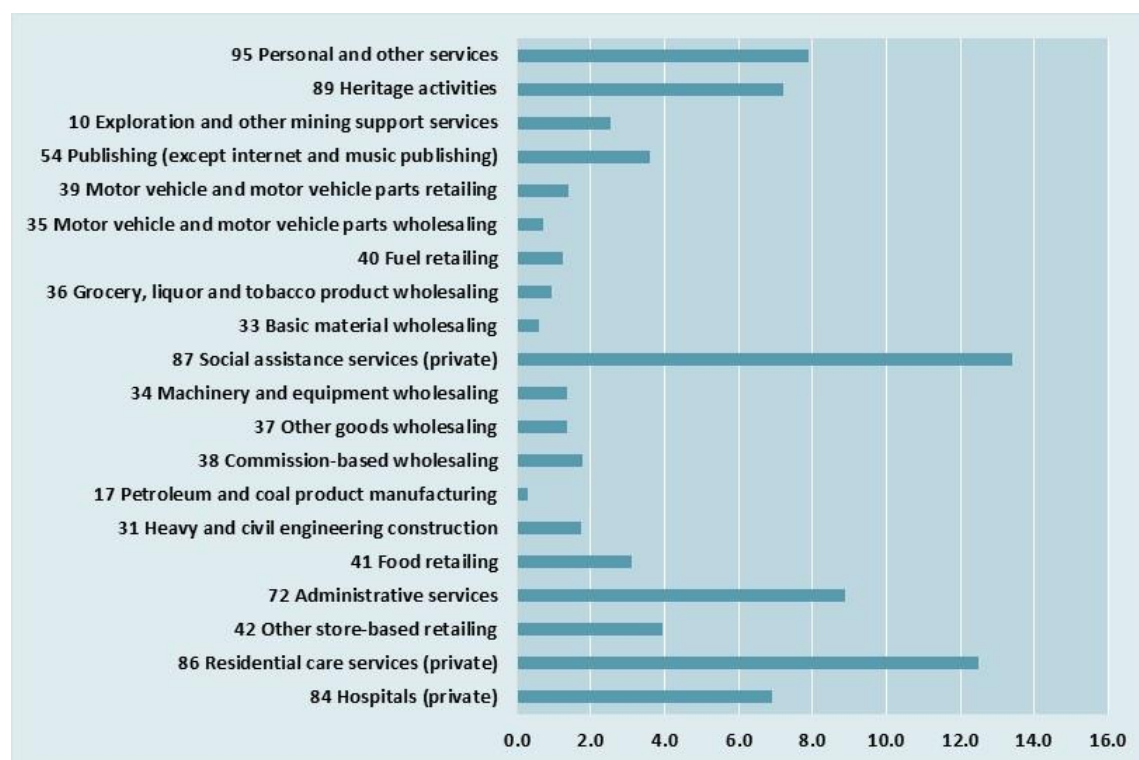


Source: Pottinger analysis of ABS data

A business could thus exceed the turnover limit of A\$10m of turnover and still generate very little profit or be loss-making. Assuming these low EBITDA margins are observed consistently over time, such businesses will have relatively low valuations and their low levels of profitability suggest that they are likely to be less sophisticated and/or less able to afford external professional advice when engaging with financial institutions.

Collectively, businesses in the bottom quartile of sub-sectors listed above account for approximately 35% of all employees and 35% of all wages and salaries. On average, these businesses employ approximately 3.0 people per million dollars of turnover, but some are materially more employee-intensive than others. We illustrate this below, with subsectors ranked in order of lowest EBITDA margin to highlight those that are most exposed.

Figure 34: Employment intensity of low margin businesses ranked by EBITDA margin (low to high)



Source: Pottinger analysis of ABS data

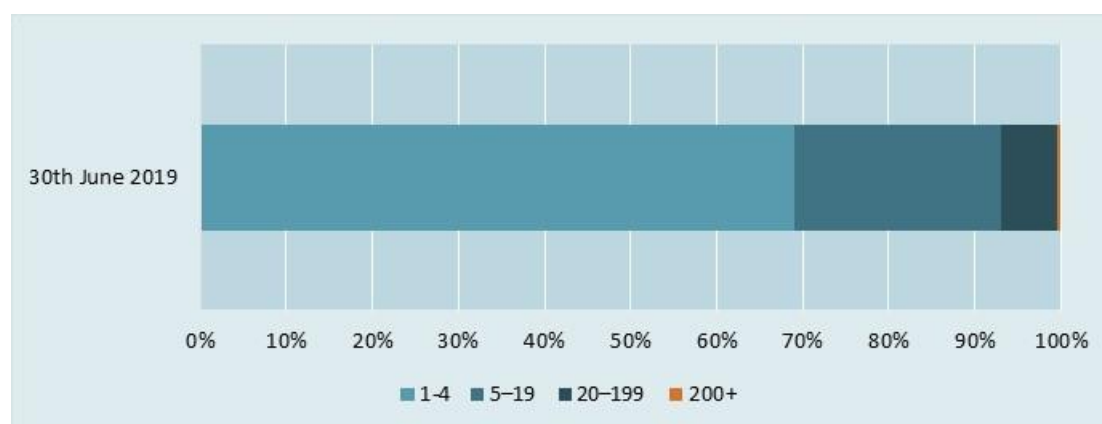
These figures illustrate that the requirement for a business to satisfy all criteria simultaneously may exclude from protection high-turnover, low-margin businesses. There is a particular concentration of these businesses in the retail and wholesaling sectors.

Overall, in the interests of simplicity, we do not believe there is a case for adopting a more complex set of criteria that use different values for revenues and/or employee numbers according to the nature of a company's activities.

3.7 Application at an individual company or group level

We have been unable to source any data on the number of groups of companies that exist in Australia based on the application of the criteria used by the Code. As noted earlier in this section, 1.49 million of the 2.38 million companies included in ABS analysis of the business sector do not have any employees. Even if these non-employing businesses are excluded from our analysis, companies employing fewer than 20 employees accounted for 93% of all businesses in Australia as at 30th June 2019, as illustrated below.

Figure 35: Composition of businesses with employees by size



Source: Pottinger analysis of ABS data

Overall, we have not seen any evidence to suggest that the data presented by previous reviews on the proportion of businesses that are protected by the Code is misleading.

3.8 Application at a facility or aggregate borrowings level

We are not aware of any data that can cast light on the extent to which applying the borrowings criterion at a facility level would increase the number of businesses protected under the Code.

We are also not aware of any data that quantifies the extent to which enterprises are excluded as small businesses as a result of being treated as part of a group of companies.

Meanwhile, as we explore further in the following section, we anticipate that there may be a significant number of large and sophisticated companies that could qualify for protection under the Code if the borrowings criterion was applied at a facility level.

In this context, we note that AFCA "independently assists consumers and small businesses to make and resolve complaints about financial firms". Any small business (which it defines as an organisation with fewer than 100 employees³⁶, or any registered charity) can use its service, so long as the credit facility in question is under A\$5 million. An organisation could thus have access to AFCA but nevertheless not be treated as a small business under the Code. Meanwhile, if the lending bank does not subscribe to the Code, it will not apply in any event. As a result, AFCA must assist customers of similar size and sophistication whose facilities fall both within and outside the code.

3.9 Definitional issues identified during our review

There is considerable complexity in applying certain aspects of the definition of small business used in the Code, including in relation to the treatment of groups of companies and other organisations.

Currently, the criterion related to aggregate borrowing takes 'related entities' into account based on the definition of that term set out in Section 9 of the Corporations Act 2001. Related entities include a broad set of legal and natural persons, including (by way of example) relatives, beneficiaries under a trust, trustees and related bodies corporate (ie other corporate legal entities).

³⁶ Including all employees in related companies

The definition of ‘related entities’ does not, however, include legal entities which are affiliated or organised under certain joint venture or partnership structures, or include the legal entity of a trust itself (ie, other than the trustee or beneficiary, which are expressly included).

The use of the Corporations Act 2001 definition of ‘related entities’ thus creates two challenges.

- Certain groups of associated businesses may find themselves characterised as ‘related entities’ and thus, when taken together, exceed the borrowing limit, notwithstanding that they are businesses that should enjoy the protections of the Code. The most common example of this definitional challenge cited by regional-focussed banks consulted was agribusinesses, particularly collectives of modest, family-owned farming businesses; and
- There is inconsistent and potentially asymmetric treatment of businesses which are organised around joint venture, partnership or trust structures, even though such businesses often constitute a single economic group and have common ownership and/or shared capacity and financial resources.

We acknowledge that using the Corporations Act 2001 definition is appealing in that it ensures a common approach across many areas of business. Nevertheless, it is clear from our review that the use of this definition creates material challenges in applying the Code, particularly in the agricultural sector.

To address the uncertainty that these issues may create, each bank that complies with the Code may implement policies and practices, and these may vary from institution to institution. This creates an additional source of uncertainty for small business customers.

Meanwhile, it is not straightforward for an enterprise to determine whether or not it qualifies to be treated as a small business under the Code. Unless the customer is advised by the bank in question that it has been afforded small business status, the customer requires knowledge and understanding of:

- The definitions used in the Code;
- The Corporations Act 2011 definition of related entities; and
- In some cases, certain aspects of the Australian Financial Services regime.

This creates complexity and uncertainty for small enterprises. In addition, as some stakeholders have identified, this may also create reputational risk for banks if customers believe that they should be treated as a small business but are in fact excluded from protection under the Code.

3.10 Observations and conclusions

Overall, our desktop research supports the conclusions from previous reviews regarding the extent of businesses covered under the current definitions used by the Code. In addition, the definitions used by the Code should be kept as simple and transparent as possible.

Meanwhile, the requirement for an enterprise to satisfy all three criteria to qualify as a small business under the Code will necessarily lead to some businesses being excluded. There is evidence that these businesses may be concentrated in sectors such as retail and wholesale trade, as well as in businesses that employ relatively large numbers of lower paid staff, including community care. We were mindful of these issues in gathering further information as part of our stakeholder engagement exercise.

4. Findings from previous reviews

4.1 A brief history of the definition of small business

Prior to 1981, the manner in which Australian banks dealt with customers was subject to detailed regulations imposed by the Federal Government. Following the 1981 Campbell Committee report, the extent of this regulation was significantly reduced³⁷, reflecting its recommendation that the Government pull back from intervention in the financial services industry to allow for a more competitive market system.

The Australian Government appointed a committee headed by Stephen Martin to investigate the issues arising from the Campbell Committee report and make recommendations³⁸. In its 1991 report, the Martin Committee concluded that the banks should be required to establish a formal system of self-regulation based on a government-approved Code of Banking Practice.

The first Code of Banking Practice was issued by the ABA in November 1993 and took effect in November 1996. At that time, the Code only applied to banks' interactions with individual customers. The Code was updated in August 2003 to extend its protections to small business customers.

At that time, small business was defined as an organisation employing:

- Fewer than 100 full-time (or equivalent) people if the business comprised or included the manufacture of goods; or
- In other cases, fewer than 20 full-time (or equivalent) people.

The Code was then updated in 2013, however, there was no change to the definition of small business as per the version used in 2003. The above definition remained in effect until the June 2019 update to the Code, at which point the definition became:

A business is defined as a "small business" if, at the time that it obtains the banking service in question, all of the following apply:

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

The Code was updated entirely after the request of an independent review from Phillip Khoury by the ABA. The definition of small businesses was updated so that more 'small businesses' were able to benefit under the Code's protections.

Over recent years, there have been several reviews of the definition of small business, including the Khoury Review, the Hayne Royal Commission and the ASBEFO inquiry into small business loans. We summarise the findings of each of these reviews as they relate to small businesses below.

³⁷ Banking in Australia Today, *The History of Australian Banking*, Presentation to Phil Khoury: ABA Reviewer (2016) <<https://www.bankinginaustraliatoday.com/images/Stories/BankingCode/161020-ABA-Code-Review-121p.pdf>>.

³⁸ The House of Representatives Standing Committee on Finance and Public Administration (Cth), *A Pocket Full of Change*, Report (1991).

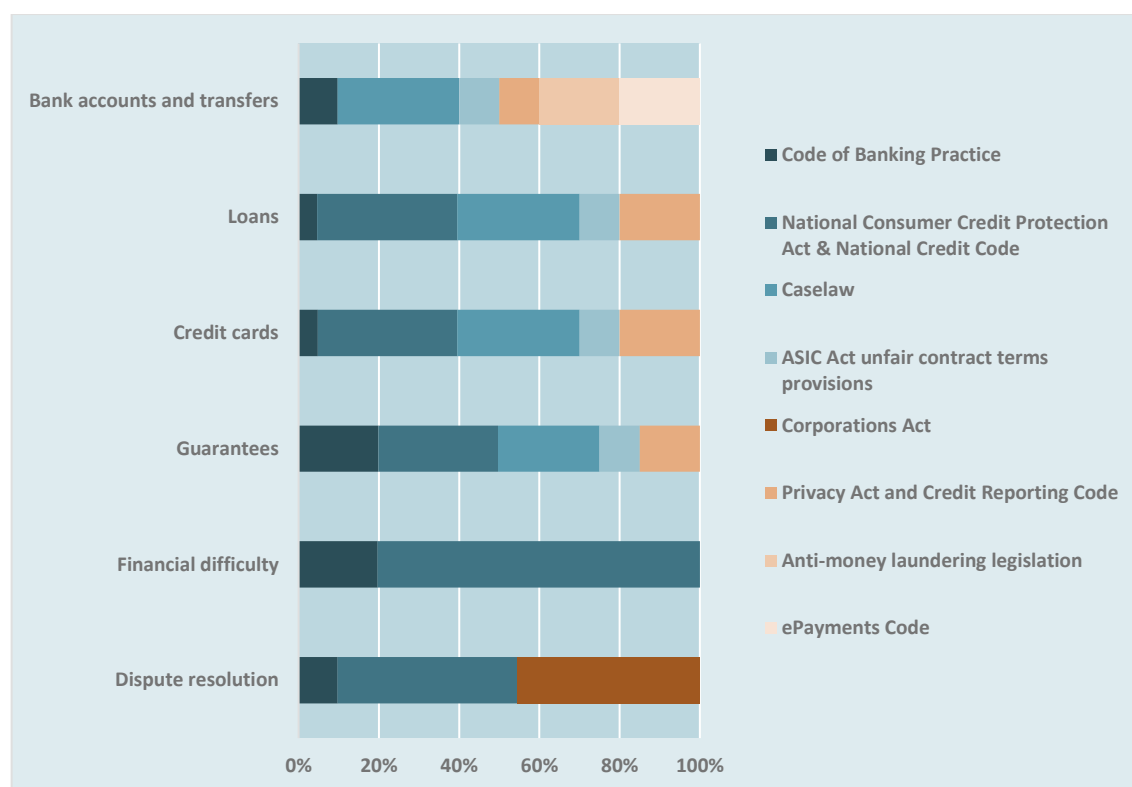
4.2 The Khoury Review

In July 2016, Phil Khoury was appointed by the ABA to undertake a comprehensive independent review of the Code (the Khoury Review). The report arising from the review was published in January 2017³⁹ and concluded, amongst other things, that:

“a new Code (along with other Better Banking initiatives) will provide the industry with an opportunity to signal a new way of working and will be a worthwhile endeavour”.

The Khoury Review notes that the provisions of the Code are applicable to a variety of products, services and events, all of which are also subject to other legal requirements which continue to evolve, creating “a complex tapestry of obligations”. The Khoury Review estimated that the Code accounts for about 10% of the requirements with which signatories to the Code must comply. This further varies across categories, as illustrated below.

Figure 36: Relative significance of requirements imposed on banks from different sources



Source: The Khoury Review, figure 1

According to the Khoury Review, the rationale of the Code’s definition of small business is that a business with a small number of employees “is unsophisticated and does not have ready access to specialist resources such as legal and financial advice”. There was no criticism of the rationale of such unsophisticated businesses having the need to benefit from the protections of the Code from any of the stakeholder discussions that took place. There was, however, significant criticism of the Code’s definition of small business.

Specifically, the Khoury Review determined that organisations that had a large asset base and which thus might require complex credit facilities could have a small number of employees and thus be classified as a small business for the purpose of the Code. Conversely, a farming

³⁹ A copy of the Independent Review is available from this link.

enterprise with a large number of seasonal workers might not qualify for the protections under the Code, at least for part of the year.

To address these challenges, the Khoury Review recommended broadening the definition to include organisations with fewer than 100 employees. This expansion was calculated by Australian Bureau of Statistics to expand the small business net from 97% of actively trading businesses in Australia to 98%.

The Khoury Review recommended that the provisions of the Code that relate to credit should only apply to small business credit facilities below A\$5. The ABA's submission to the Khoury Review⁴⁰ proposed that the less than 20 full time equivalent employee test (or 100 in the case of a manufacturer) should include exclusions – for borrowers of at least A\$3m, for businesses with annual turnover of at least A\$5m and for companies in a corporate group with a total credit exposure of at least A\$3m to A\$5m.

The final recommendation from the Khoury Review was to amend the definition as follows:

Recommendation 5

- The Code definition of “small business” (other than for the purposes of financial products or services regulated by the Corporations Act 2001) should be amended to mean a business that employs fewer than 100 full time equivalent employees or, in the case of a business that is part of a group of companies, the group employs fewer than 100 full time equivalent employees
- The provisions of the Code that relate to credit should apply to a small business credit facility only if it is below A\$5 million

The Khoury Review notes that referring to 100 full time equivalent employees “would better accommodate businesses such as farming enterprises that increase their workforce on a seasonal basis”.

The Khoury Review considered whether the borrowing limit should be applied at an individual facility level or to aggregate borrowings. It argues that the complexity of a company's borrowing requirements is better reflected by the size of each individual facility rather than the aggregate of all facilities in use at any point in time. It concluded that a facility limit was appropriate, stating:

“a credit facility above that amount often takes on a heightened level of complexity. In the interests of simplicity and a broad reach for the Code, I think that the credit facility limit threshold should be applied per credit facility, rather than on the basis of aggregating all credit facilities provided to that borrower.”

4.3 The Hayne Royal Commission

Following widespread media commentary about misconduct within the Australian financial services industry, on 14th December 2017 the Australian Government established The Hayne Royal Commission.

The Honourable Kenneth Madison Hayne AC QC, a former Justice of the High Court of Australia, was appointed as the sole commissioner, subsequently submitting an interim and a final report, following seven rounds of public hearings and over 10,000 public submissions. Amongst other things, Hayne's final report identified “conduct by many entities that has taken place over many

⁴⁰ As cited in the Independent Review, page 47, available from this link

years causing substantial loss to many customers but yielding substantial profit to the entities concerned".

Part of the report addresses the proposed definition of small business put forward by the ABA and by the Khoury Review. Hayne considered the definition of small business in the 2019 Banking Code to be "too complicated and too confined in its reach". Hayne concluded that the definition of small business laid out in the Khoury Review should be adopted.

Recommendation 1.10 – Definition of small business

The ABA should amend the definition of small business in the Banking Code so that the Code applies to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than A\$5m.

The Hayne review concluded that there was no reason to doubt the evidence that adopting this approach would have a relatively small effect, extending coverage of the provisions to an additional 10,000 to 20,000 businesses.

Finally, whilst the Hayne report does not examine the issue of whether this limit should be applied at an individual facility level or an aggregate borrowings level Hayne does nevertheless state that "I favour the definition of small business and small business facility proposed by Mr Khoury after his detailed review of the Code and its operation". As described earlier in this chapter, the Khoury review explicitly recommended that the credit test should be applied on a per facility basis.

4.4 The ASBFEO Inquiry into Small Business Loans

In September 2016, the ASBFEO was asked by the former Minister of Small Business, the Hon Michael McCormack MP to conduct an inquiry⁴¹ into the adequacy of the law and practices governing financial lending to small businesses.

The Ombudsman concluded that there was "almost complete asymmetry of power in the relationship between banks and small business borrowers". This created:

- "Extremely complex, one-sided contracts that yield maximum power to banks to make unilateral changes whenever they like and without the agreement of borrowers
- Inadequate timeframes around key loan milestones that leave borrowers vulnerable
- Misleading and conflicting signals between bank sales staff and credit risk staff which leaves borrowers vulnerable
- Lack of transparency and potential conflict of interest in dealings with third parties involved in impaired loan processes, such as valuers, investigative accountant and receivers
- Significant gaps in access to justice with nowhere to go except the court system, with borrowers having limited resources and banks having overwhelming resources"

One of the recommendations made by the Ombudsman was:

Recommendation 2

The revised Code of Banking Practice 2017 be approved and administered by the Australian Securities and Investments Commission under Regulatory Guide 183. The Code must be written in plain English and include a dedicated section on small business clarifying how breaches will be enforced.

⁴¹ The Inquiry into small business loans is available from this link.

This meant that the Code should have a dedicated small business section and that the language used within the Code should be simple. The rationale behind this change was to recognise that small businesses are treated differently to individuals.

There was no explicit recommendation on the definition of small business that was used within the Code. However, five of the 15 recommendations refer to a credit or debt facility of less than A\$5m being the minimum standard for 'small businesses' to have protection under the Code. These included:

- **Recommendation 3**, related to when banks can declare loans in default;
- **Recommendation 4**, requiring banks to provide 90 business days' notice on roll-over decisions;
- **Recommendation 6**, requiring banks to provide a one-page summary of the clauses and covenants that may trigger default or other detrimental outcomes for borrowers;
- **Recommendation 7**, requiring banks to put in place a new small business standard form contract that is short and written in plain English; and
- **Recommendation 11**, requiring the banking industry to fund an external dispute resolution one-stop-shop with a dedicated small business unit that has appropriate expertise to resolve disputes relating to a credit facility limit of up to A\$5 million.

The ASBFEO Inquiry did not explicitly consider the question of whether a borrowings limit should be applied at an individual facility level or be based on aggregate borrowings. Nevertheless, where its recommendations refer to borrowing limits, it refers to an individual facility size of A\$5m.

4.5 Observations and conclusions

These reviews reach several consistent conclusions that are relevant to our review, namely that the definition of small business should:

- Continue to reference businesses employing fewer than 100 employees;
- Use a borrowing limit of A\$5m rather than the current A\$3m;
- Apply the borrowing limit to individual facilities rather than to aggregate borrowings; and
- Apply all tests based on the group in question, rather than the individual company.

Meanwhile, the commentary in the various reviews also appears to be consistent with retaining the criterion related to revenues and the current approach that all three criteria must be met in order to be classified as a small business.

5. Stakeholder engagement findings

5.1 Overview of our approach to stakeholder engagement

In order to ensure that our review took account of the perspectives of a range of relevant stakeholders, we sought input to our review from:

- The banking industry, including the ABA and its members as well as other banks that are not members of the ABA;
- Consumer and small business organisations;
- Relevant regulatory bodies;
- Other interested stakeholders, including AFCA; and
- Small businesses themselves, both via a direct questionnaire and through professional services businesses that deal extensively with small businesses.

Stakeholders were invited to attend one of a series of confidential stakeholder forums. Each forum focused on one type of stakeholder, with individual banks invited to attend a forum with other banks of a similar size and nature. Each stakeholder was also offered the opportunity to participate in a further one-on-one discussion. We summarise below the stakeholders with whom we engaged.

Figure 37: List of stakeholders consulted directly

Group	Stakeholders
ABA members	AMP Bank, ANZ, Bank Australia, Bank of America, Bank of Queensland, Bank of Sydney, Bendigo and Adelaide Bank, Commonwealth Bank, HSBC, Macquarie, MyState Bank, NAB, Rabobank, Suncorp, Westpac
Non-member ADIs	Auswide Bank, CUA, Judo, PayPal, RACQ Bank, Tyro
Consumer and small business organisations	Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Consumers' Federation of Australia, Council of Small Business Organisations Australia (COSBOA), Financial Counselling Australia, Consumer Action Law Centre, Legal Aid Queensland, Small Business Association of Australia
Regulatory bodies	Australia Government Department of Treasury, The Banking Code Compliance Committee (BCCC), Council of Financial Regulators, Reserve Bank of Australia (RBA)
Other stakeholders	Australian Financial Complaints Authority (AFCA), Customer-Owned Banking Association (COBA), Eftpos, South East Community Links
Accounting firms	Hassos & Associates, Wilson CA

In addition to these discussions, several stakeholders took the opportunity to make written submissions, including:

- The ABA;
- The Banking Code Compliance Committee; and
- The Small Business Association of Australia.

We provide brief summaries of these submissions later in this section and have attached the full submissions as an appendix to our report.

Finally, we note that, whilst the majority of Pottinger's clients are large businesses and Governments, we are also actively engaged with the start-up and SME community in Australia. Through this work, we have regular first-hand experience of the issues faced by small businesses in Australia in engaging with lending organisations, including both banks and non-bank lenders.

5.2 Key issues for stakeholder engagement

Throughout our stakeholder engagement, we used a common framework to ensure consistency in our discussions and in the information gathered. This included specific discussion of:

- The criteria used by the definition;
- The values used in each of the criteria;
- Whether the criteria should be applied at an individual company or group level;
- Whether any condition related to borrowings should reference an individual facility or an aggregate level of borrowings;
- The potential impact of any changes that were recommended to the definitions; and
- Any other issues that stakeholders believed should be considered.

We also specifically sought feedback on the recommendations from the Khoury review and the Royal Commission, namely:

- Whether stakeholders agreed or disagreed with the recommendation of the Khoury review that the relevant limit within the Code should be increased from A\$3m to A\$5m, and the impact that they believe this might have on their businesses;
- Whether stakeholders agreed or disagreed with the recommendation of the Royal Commission that small business should be defined as any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than A\$5 million; and
- Whether stakeholders agreed or disagreed with the March 2019 Quarterly Statement of the Council of Financial Regulators, ie that "a limit based on total credit exposures is more appropriate than one based on loan size."

The following sections provide details of our findings.

5.3 Findings from our stakeholder engagement discussions

Overall, there is strong and broad support for the Code from all the stakeholders with whom we have engaged. There was also consistent feedback that:

- The definition of small business should remain as simple as possible;
- All criteria should be applied at a group rather than individual legal entity level;
- The borrowings criteria should be based on aggregate borrowings from all lenders, rather than on the size of an individual facility⁴²;
- There would be considerable merit in greater alignment between the different definitions of small business used across the Australian legal and regulatory landscape; and
- There are terminological challenges that complicate application of the existing definition.

As an overarching matter, most stakeholders consider supporting more small businesses, rather than fewer such enterprises, to be an appropriate guiding principle. This is especially relevant having regard for the challenging operating environment brought on by the COVID-19 crisis. This approach is consistent with the operating practice of many banks to apply just one, rather than two or all, of the criteria used in the current definition of small business to determine a customer's eligibility for protection under the Code.

Moreover, on the matter of the aggregate borrowings criterion, ASIC submitted that while A\$3m captures the vast majority of the small business group, it does see value in extending the

⁴² This approach is not supported by AFCA, the BCCC and the Small Business Ombudsman, all of which support applying the definition at an individual facility level

Code's protections to as many customers as possible, and ASIC is thus open to an increase to the relevant borrowings limit.

We expand further on these themes below.

Keeping it simple: No stakeholders consulted support the need for any further or different criteria to be included in the definition of small business. Certain stakeholders cautioned us about adding carve-outs to individual criteria, even though several stakeholders, particularly regional and smaller banks, commented that the definition sometimes yields perverse findings, particularly in relation to agribusiness.

Application at a group level: Most stakeholders consulted believe that each of the criteria should be applied at a group level, rather than at an individual legal entity level. No stakeholders argued that the employee number or revenue tests should be applied at an individual legal entity level.

Consolidated borrowings: No bank consulted supported the finding in the Royal Commission that the limit should be A\$5m per loan. Meanwhile, AFCA, the BCCC and ASBFEO all support a definition based on individual facilities. All other stakeholders supported the application of a borrowing criteria based on aggregate borrowings from all lenders across a consolidated group.

Unifying the definition of small business: Almost all stakeholders suggested that there would be significant advantages in unifying the definition of small business. No stakeholders, however, expressed a view as to how this could be achieved or where this might lie on the significant spectrum of definitions currently in use.

Clarifying the definitions: Almost all stakeholders agreed that the definitions needed to be tightened up, particularly in relation to what types of entity should be considered as related entities when determining which legal entities should be counted as part of a group for the purposes of applying the Code. A number of stakeholders emphasised particular issues related to the treatment of agricultural businesses.

Minimum standard: There is broad acknowledgment that the requirement to satisfy all three criteria creates a minimum standard and this approach is generally supported. We note, however, that the BCCC proposed in its written submission that an enterprise should only be required to satisfy one criterion to qualify as a small business.

In the remainder of this section, we summarise the perspectives provided to us through our engagement with stakeholders through both stakeholder forums and one-on-one meetings.

Approach to applying the Code

Based on our stakeholder discussions, different banks apply the Code in different ways. This is consistent with the BCCC's Inquiry, during which eleven banks confirmed that they were already applying the Code to a broader range of small business customers than the current definition requires.

For example, a significant number of banks focus primarily on the aggregate borrowing criteria to determine whether a bank is a small customer. In many cases, these banks usually disregard the other criteria. As a result, it is possible for a customer to be classified as a small business by one bank and not by another.

In addition, some banks indicated that different divisions of their organisation may adopt a different approach. For example, branch-based banking might use solely the aggregate borrowings criterion, whereas the institutional bank might use all three criteria. As a result, a

customer might be categorised differently depending on which part of the bank was responsible for the overall relationship.

Understanding whether or not a customer qualifies for protection under the Code

One submission raised the concern that a bank might classify a customer as a small business as a result of applying solely the aggregate borrowing criteria, but could then seek to apply the other criteria to exclude the protections of the Code in the event of a complaint or other investigation. This is consistent with the BCCC's Report of its Inquiry into banks' transition to the 2019 Code, which was published in November 2019. This stated that:

"The BCCC is concerned that 2 of the 11 banks adopting a broader definition of small business, have reserved the right to contend that the Code does not apply to the relevant customer in the event of a BCCC investigation. The BCCC finds this unacceptable and expects that the Code's small business obligations, if broadly applied by a bank, should continue to apply for the purposes of any BCCC inquiry or investigation."

Where a bank has chosen to adopt a broader small business definition, it should not later assert the relevant Code obligations do not apply."

In relation to the above issue, we note that, if a bank advises a customer that it is being treated as a small business customer, then the customer in question can rely on this status under Australian law, as otherwise the bank concerned could be accused of 'misleading or deceptive conduct'. This assumes that the customer's classification under the definition has not changed.

We understand that, whilst banks seek to ensure that, where relevant, their documentation complies with all relevant requirements for doing business with small business customers, these customers may not know, nor be advised by the bank, whether they are eligible to be treated as small business customers under the Code.

If the customer is not advised of its status, then, if a customer wishes to ascertain whether it is protected, it would need to:

- Determine whether it meets the three conditions under the Code (and monitor this status over time);
- In doing so, take account of the definition of 'related entities' in the Corporations Act 2001; and
- Identify whether it is excluded through being classified as a wholesale customer under the Australian financial services legislation.

In practice, reviewing this documentation and determining its implications will not be a straightforward matter for many small businesses.

The Code as a minimum standard

We found there to be broad support for the concept that the Code represents a minimum standard supported by the banks, and that there was merit in banks having the freedom to adopt standards that included more customers as small businesses than might otherwise be the case. For example, we understand that several banks have already implemented the recommendation that a A\$5m borrowing limit be used to qualify a business as a small business.

Impact of changes to aggregate borrowings limit under the Code

Almost all banks indicated that increasing the aggregate borrowings limit from A\$3m to A\$5m is feasible. We note that several banks have already implemented this change, demonstrating that this change is both feasible and beginning to be embraced by the banking sector.

Meanwhile, several others noted that implementation would benefit from appropriate planning in order to limit incremental implementation costs, risks and complexity.

Several banks noted that implementing changes to the Code of this nature in the short term could distract from other initiatives designed to support business customers through the current difficult trading environment.

Two mid-sized banks suggested that changing the definition of small business, particularly in relation to increasing the borrowing criterion, could have an adverse impact on competition and access to credit, though these views were neither definitive nor supported by specific evidence.

Finally, stakeholders expressed a wide range of views regarding the desirability of changes to the Code, as well as the timing of and notice for such changes, especially in relation to the borrowing limit of A\$3m. The range of these views encompassed:

- Strong support for the increase of the aggregate borrowing limit to A\$5m (with this change having already been implemented);
- Support for an increase of the borrowing limit to A\$5m, so long as there was a reasonable notice period;
- Openness to changes to the criteria, so long as such changes were implemented in one step, with at least around 12 months' notice followed by a transitional period;
- Caution regarding the desirability of changes, at least in the near term; and
- Significant reservations regarding the benefits, costs and risks of making any changes to the borrowing limit of A\$3m, at least in the next one to two years.

Taken together, we interpret these views as being supportive of changes designed to improve the clarity and precision of the definition of small business under the Code and to increase business confidence in its application. This includes:

- Ensuring that the definition used remains as simple as possible;
- Amending the definition to improve the way that related entities are defined;
- Applying all criteria at a group rather than individual legal entity level;
- Basing the borrowings criterion on aggregate borrowings from all lenders; and
- Moving to an aggregate borrowings limit of A\$5m in due course.

5.4 An overview of written submissions provided to Pottinger

Several stakeholders provided Pottinger with written submissions on various matters relevant to our review, including:

- The ABA;
- The Banking Code Compliance Committee; and
- The Small Business Association of Australia.

We are appreciative that the organisations have each given their permission for their submissions to be made public and accordingly they are attached to our report. We provide a brief summary of the main issues raised in each of these submissions below.

The Australian Banking Association

The ABA provided a submission to Pottinger on 12th October 2020. The key observations included in the ABA's submission included the following:

- A turnover of A\$10m is an appropriate marker of business sophistication;
- A threshold of 100 full-time equivalent employees should be retained;

- The current definition of small business, under the credit criterion for total credit exposure of A\$3m “appropriately reflects policy intent behind the Code of ensuring small businesses have the benefits of its protections whilst leaving larger more sophisticated businesses free to negotiate appropriate conditions with their bank”; and
- The three criteria should remain at a group level and the credit threshold criterion should not be changed to a ‘per facility’ basis.

The submission noted: "In order to meet the more sophisticated, complex and variable needs of larger businesses banks should have flexibility in loan structuring to provide customers with appropriate and bespoke solutions. This is less critical with simpler and more homogenous lending structures typical of smaller businesses which also benefit from the support detailed in the Code."

The ABA submission also raised the issue that "some aspects of the current definition render open the possibility that larger, more sophisticated businesses, which were clearly not intended to be covered by the Code, are technically captured". The ABA provided suggestions on how to address this issue which we address later in our Report.

In addition, the ABA's submission also highlighted the potential inconsistency of treatment of some unincorporated business structures, such as trusts, partnerships and joint ventures that fall outside the definition of ‘related entities’ under the Corporations Act.

Finally, the ABA submission also noted the following in relation to timing:

"An appropriate implementation period is required in order to operationalise and implement any significant changes to the Code. This is necessary, for example, to effect changes to documentation and processes, review portfolios to identify impacted customers, and provide appropriate training to staff.

In addition, in our view the Review should consider whether any change to the current settings for lending under the Code are warranted or desirable in the current economic environment, and whether any changes should be deferred for an appropriate period to account for the period necessary for the economy to recover from the effects of the pandemic.

In our view, a period of at least 12 months from the time of any ASIC approval would be preferable, and at least 6 months, necessary."

The Banking Code Compliance Committee (BCCC)

The BCCC is an independent compliance monitoring body established under clause 207 of the Code. We provide a brief summary of the key points raised in its submission below:

- Eleven banks explained to the BCCC that they intended to adopt a broader definition of small business under the Code. However, “the BCCC is concerned that 2 of the 11 banks adopting a broader definition of small business, have reserved the right to contend that the Code does not apply to relevant customers in the event of a BCCC investigation.” The BCCC concludes by saying “where a bank has chosen to adopt a broader small business definition, it should not later assert the relevant Code obligations do not apply”;
- “Without exception, banks must develop capabilities for reporting small business data to the BCCC. Banks need to provide consistent reporting to allow for benchmarking and year on year comparisons”; and
- The BCCC emphasised that, in relation to small business, "it is very important for there to be a uniform definition across the industry. The BCCC noted that there was no uniform definition across the industry on small business. Specifically, the BCCC noted that AFCA

whilst noting the 100-employee criterion, there is a difference in the credit facility between A\$3m and A\$5m and it does not include a turnover criterion.

Regarding the criteria, the BCCC and its Panel commented that:

- The current total credit criterion excluded small businesses and farmers where total facilities exceeded A\$3m and recommended updating the A\$3m criterion to the A\$5m threshold. An increase in the threshold would “lead to more consistent application across industry and, less confusion and more consistent outcomes for small business customers”;
- The small business definition should be based on a per facility calculation rather than a total credit exposure calculation;
- The three criteria should be subject to “or” rather than an “and” condition; and
- Irrespective of the overall small business definition there should be a carve-out in the scope of the definition for “family-owned farms and other businesses in the agricultural sector with greater than A\$5m in credit [as they] are not necessarily large or sophisticated borrowers”.

Small Business Association of Australia

The Small Business Association of Australia provided a submission on 22nd October 2020. The SBA submission made the following points:

- There are numerous definitions of small business in Australia which causes confusion;
- Revenue turnover should be increased from A\$10m to A\$50m;
- Full-time equivalent employees should be increased from 100 or fewer to 250 or fewer; and
- The credit criterion should be increased from A\$3m to A\$10m or less.

5.5 Findings from our public stakeholder questionnaire

We also provided an avenue for the general public to provide feedback on the current definition of small business, via a questionnaire. This was promoted via social media with the support of the ABA and various other stakeholders. We provided respondents to the questionnaire with a brief summary of the current definition and application of the definition of small business, together with the overview of our areas of focus set out below.

Figure 38: Public questionnaire – background information provided

Interested parties are invited to submit their perspectives on the current definition of small business under the Code by completing the questionnaire. This includes gathering your views on:

- The importance of the Code in ensuring appropriate standards are adopted by banks in relation to small business customers
- Whether or not changes should be made to the criteria used to define what constitutes a small business
- Whether or not changes should be made to the thresholds used in these criteria
- Various other issues related to the impact of the Code on both financial institutions and their customers
- Any other matters you may think are relevant to our review.

Source: Pottinger⁴³

⁴³ Pottinger webpage created for the Independent review of the definition of small business link can be here

The response rate to the questionnaire was modest, but nevertheless provided additional data which was broadly consistent with both our desktop analysis and stakeholder engagement exercise.

There was broad agreement that the Code provides important protections to small business banking customers. We provide a summary of the responses to the survey below.

- A wide variety of views were expressed on both the turnover test and the employee number test. Almost all respondents were in favour of retaining at least one of these tests, but there was no consensus regarding which one with approximately two thirds of respondents supporting the retention of each test;
- Very few respondents were in favour of discontinuing both tests and these people did not suggest an alternative approach;
- Stakeholders did not express clear support either for retaining or discontinuing the test linked to aggregate borrowings, though we note very few were in favour of removing it;
- About half of all respondents who expressed an opinion favoured retaining the existing values used in the criteria;
- For the turnover criterion and the employees criterion, there was no clear consensus amongst those favouring change regarding what the new values should be;
- All respondents who favoured updating the credit criterion supported adopting a A\$5m limit;
- A majority of respondents favoured applying the revenue and employee number criterion at a group level; and
- Respondents were evenly split regarding whether to apply the borrowings criterion on an aggregate borrowings or individual facility basis.

We note that a number of responses to our survey came from organisations that had also participated in stakeholder group discussions and/or one-on-one meetings. Accordingly, we also reviewed the survey findings with these responses excluded. The only notable difference was that the clear majority of this subset of responses favoured discontinuing the use of the aggregate borrowing criterion.

We note that it is an understandably difficult time to capture the attention of small business for the purposes of this review given competing priorities and challenging operating conditions for many Australian enterprises.

Nevertheless, one logical inference from the public questionnaire data is that small businesses are also seeking a simple mechanism to understand how they are categorised under the Code.

5.6 Observations and conclusions

Overall, our stakeholder engagement exercise confirms that there is broad support for:

- The definition of small business to remain as simple as possible;
- The existing criteria to be retained;
- The values used in the employee number criterion and the revenue criterion to be retained;
- The criteria to be applied at a group level, rather than an individual company level;
- The borrowings criterion to continue to be applied to aggregate borrowings rather than at an individual facility level and for the limit to be increased to A\$5m in due course;
- Refinement of how related entities are defined to recognise certain types of legal entity not currently addressed by the current definition and to improve the treatment of businesses that operate independently but which (for example) are owned by members of a single family; and
- A measured approach to the implementation of these changes that are proposed.

In relation to the above, we note that AFCA, the BCCC and the Small Business Ombudsman all support applying the borrowings criterion at an individual facility level. In contrast, all banks and almost all other stakeholders strongly recommend application on a consolidated or total credit exposure basis.

Meanwhile, most stakeholders support increasing the threshold under the borrowings criterion to A\$5m. Whilst some stakeholders are cautious about benefits and the timing of such a change, no bank opposed introduction of this limit in due course.

As noted above, there is broad agreement that any changes recommended by our review should be implemented in an appropriately planned manner, in order to avoid undue cost and risk.

6. Overall observations and recommendations

6.1 Introduction and summary of findings

Our overall observations and recommendations below reflect a synthesis of our desktop research and background knowledge of the banking sector in Australia and around the world, consideration of the previous reviews that have been undertaken and the stakeholder engagement exercise. Our recommendations are also informed by the challenging operating environment brought on by the COVID-19 crisis. Whilst the time available to undertake our review was short, we are satisfied that we have had an adequate opportunity to consider the issues arising.

As an important overarching observation, there is broad support for the Code and widespread recognition of its importance in providing protection to small businesses in Australia.

Overall, there appears to be a broad consensus that the criteria used in the definition (turnover, employee numbers and borrowings) are both reasonable and appropriate, and also that these tests should be assessed at a group level, rather than an individual legal entity level.

Meanwhile, there are several areas where there is broad support for the Code to be refined, including in relation to:

- Improving the precision of the definition of small business, so that there is greater clarity and consistency regarding which enterprises are treated as small businesses;
- Giving small businesses greater confidence and transparency regarding whether or not they are (and will continue to be) treated as a small business by any particular bank; and
- Contributing to reducing the number of different definitions of small business that are used in Australia and clarifying why different definitions are used by different bodies.

As a result of our review, we have identified several areas which represent, or may be perceived to represent, loopholes in the definition of small business. These have the potential to cause confusion to customers and to create reputational risk for banks which subscribe to the Code. One particular issue is that it is not straightforward for an enterprise to determine whether or not it qualifies to be treated as a small business under the Code, as this requires knowledge of the Code, the Corporations Act 2001 definition of related entities and aspects of the Australian Financial Services regime.

Finally, whilst there is reasonable support for increasing the borrowing limit of A\$5m, there is little consensus regarding whether this is worthwhile. Whilst several banks have already implemented this shift, we note that several banks have noted the importance of careful planning to mitigate the potential cost, complexity and compliance risk of implementing any such change. No stakeholders, however, opposed adopting this limit in due course.

Our recommendations below are designed to address all of these issues, whilst giving appropriate consideration to the extent of impact (or otherwise) that any proposed change might have on the number of customers protected, the level of transparency achieved, and the cost, complexity and risk of implementation for the banks and other relevant stakeholders.

6.2 The Code as a minimum standard for bank behaviour

Based on our review, we are aware of several examples where ABA members demonstrate a more inclusive industry practice by affording the protections of the Code to a wider set of customers than would be the case if they applied a strict reading or application of the Code's three criteria. Examples include:

- Applying only the aggregate borrowings test;

- Only taking into account aggregate borrowings from the bank in question, rather than aggregate borrowings from all lenders;
- Using a A\$5m limit in applying the aggregate borrowings test;
- Considering a business on an individual legal entity basis, rather than considering all related entities in a group; and
- On occasion, applying discretion when applying the criteria to treat businesses that only marginally exceed the prescribed limits of the criteria as small businesses.

This represents a positive outcome for small businesses (so long as they are advised of their status as a small business customer and can thus rely on the relevant protections), as it means that more such enterprises benefit from the protections under the Code than would otherwise be the case.

Nevertheless, this approach may also increase confusion in the eyes of customers and other stakeholders, given the variation in standard being applied and the outcome that a company may be treated as a small business customer by one bank and not by another.

6.3 Recommendations related to the criteria used by the definition

Recommendation 1: The criteria used by the definition of small business should be retained

Recommendation 2: An enterprise should continue to be required to meet all three criteria to qualify as a small business

Based on our review, we have not seen any evidence that suggests there is a strong case to change the use of turnover, employee numbers and credit outstanding as the three core tests applied by the Code.

Meanwhile, only the BCCC suggested that the basis of application of the three tests should be changed, recommending in its written submission that only one of the three tests should need to be satisfied.

We observe that removal of any individual criterion would make some businesses with sophisticated requirements subject to the Code. These protections would in our view potentially have low value to such businesses and could inhibit the ability of banks to service them. Similarly, adjusting the use of the criteria so that only one or two of them had to be satisfied would have a similar effect.

In reaching the above conclusion, we considered the types of company that could be affected if the Code was changed so that a customer would qualify as a small business if (for example) only two of the three criteria were met. As qualitative examples:

- Waiving the revenue test would classify high revenue, asset and employee-light organisations as small businesses. Based on the data provided by ASIC, we estimate that approximately 2% of loans by ABA members to enterprises with aggregate borrowings of below A\$3m would be excluded by application of the turnover test. These may be low margin companies that generate relatively little profit and hence cannot support much debt and/or companies that are asset light and/or have low borrowing requirements;
- Waiving the employee number test would classify people-intensive businesses such as low margin labour hire businesses as small businesses; and
- Waiving the aggregate borrowings test would classify asset-intensive businesses and/or businesses with higher borrowing requirements as small businesses. Data provided by ASIC shows that, at 30th June 2020, ABA members had approximately 15,000 loans outstanding to enterprises with an aggregate borrowing requirement of between A\$3m and A\$5m.

In each case, we anticipate that the type of organisations that would benefit most from any relaxation of the definitions in this manner would be businesses with low operating margins, ie which generated relatively little profit irrespective of their turnover, employee numbers or borrowing requirements. Whilst many stakeholders raised the issue of aligning the definition of small business across different applications, there was very little support for eliminating one of the criteria or for changing the way these rules are applied so that only one or two of the three tests needed to be satisfied.

In this context, we note that a variety of stakeholders raised issues related to certain agricultural businesses not being classified as small businesses. Ultimately, our view is that the underlying issues are best addressed through refinement to the definition of related entities and the aggregate borrowing limit. We address these issues further in that context later in this section.

Establishing whether or how to rationalise the definition of small business across different bodies lies outside our terms of reference. Nevertheless, given the near-uniform feedback that greater consistency would be broadly welcomed, we make the following comments in relation to definitions currently in use.

First, we observe that the definitions used can be divided into three groups with broadly similar purposes, as illustrated below.

Figure 39: Definitions of small business in common use in Australia nationally

Purpose	Body and role	FTEs	Revenue	Debt
Employee protection	Fair Work Act – employee protection	✓		
State small business incentives	NSW	✓	✓	
	NT, QLD, SA, VIC, WA	✓		
Small-business support and protection	ATO – tax rules		✓	
	COBA – mutual banking conduct	✓		
	ASBFEO – advocacy and assistance	✓	✓	
	ABS – national statistics	✓	✓	
	AFCA – banking dispute resolution	✓		✓
	ABA – banking conduct	✓	✓	✓
Regulatory compliance	APRA – SME guarantee scheme ⁴⁴		✓	
	ASIC – requirement to prepare financial statements	✓	✓	

Second, we note that:

- The protections for small businesses set out under the Fair Work Act need to balance the needs of smaller businesses with the desire to ensure that there is appropriate employee protection for as many employees as possible. Accordingly, it is logical that the test here relates to employees and is set at a relatively low level, currently 15 employees; and
- The objectives of APRA and ASIC are both technical in nature and designed to have significantly wider impact than purely small businesses, and hence it is logical that these limits are set at a much higher level, currently A\$50m revenue (and 100 employees for ASIC).

⁴⁴ <https://treasury.gov.au/sites/default/files/2020-04/sme-guarantee-scheme-scheme-rules.pdf>

Third, within the middle category, the nature of focus of each body varies, and hence it is unsurprising that different criteria have been chosen. Thus, we believe the best opportunity to increase consistency is to focus on the values that are chosen for the criteria in question.

Increasing the aggregate borrowing limit to A\$5m would be consistent with this approach, although this argument alone is unlikely to be sufficient to justify this change in the short term.

Finally, we note that ABS currently provides data on small businesses in a series of segments for both turnover and employee numbers. Given the number of definitions which use a definition of “fewer than 100 employees”, it would be helpful for the ABS to split data presented as “20 to 199 employees” into two categories, ie “20 to 99” employees and “100 to 199 employees”.

6.4 Recommendations related to the values used in the criteria

Recommendation 3: The values used in the criteria related to employee numbers and revenue should be retained

Recommendation 4: The value used in the borrowing criterion should be increased to A\$5m in due course

Overall, a strong majority of stakeholders with whom we consulted indicated support for increasing the borrowing limit, whether in the near term or following a suitable planning, implementation and transition period. Whilst some stakeholders put forward arguments in favour of maintaining the status quo limit of A\$3m consistent with our commentary in this section, all were open to moving to a limit of A\$5m in due course. In other words, concerns related to this change related more to the timing for such a change, rather than reflecting outright opposition to the value recommended in the Khoury Review, the Hayne Royal Commission and the ASBFEO Inquiry into Small Business Loans.

In undertaking our review, we are aware that considerable effort, research and analysis has gone into developing the version of the Code that is currently in effect. This work has included evaluation of the recommendations of previous reviews, leading to the consideration of the issues by the Council of Financial Regulators in March 2019. The Council ultimately agreed that, on balance, the ABA’s proposed A\$3m total credit exposure threshold should be maintained pending this independent review.

Our review has confirmed that application of the existing employee number and revenue criteria result in almost all Australian enterprises being treated as small businesses. These companies thus benefit from the protections of the Code, assuming such companies bank with an ADI that subscribes to the Code and do not fall into one of the exemptions from the Code.

Meanwhile, our stakeholder engagement exercise has also confirmed that most banks use the aggregate borrowings requirement as their primary basis for assessing whether an enterprise should be categorised as a small business customer for the purposes of the Code.

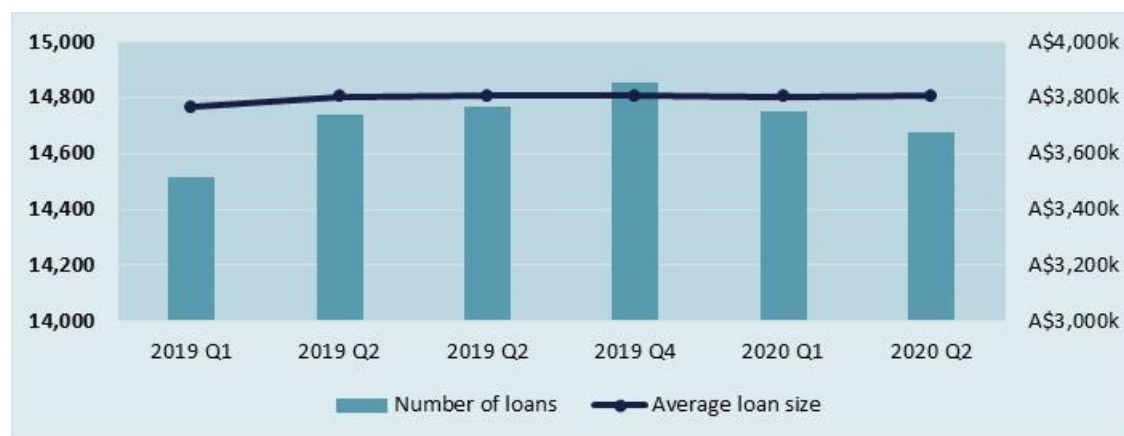
We also understand from our stakeholder engagement exercise that several banks have already responded to the recommendations made by the Khoury Review, the Hayne Royal Commission and the ASBFEO Inquiry and increased the borrowing limit they apply to A\$5m. As we outline further in section 6.6 (application of the borrowings limit), we believe that this limit should apply to aggregate borrowings by the business in question.

Meanwhile, consistent with previous reviews, our review has confirmed that increasing the value used in the borrowings criterion would result in only an additional 10,000 to 20,000 enterprises being treated as small business customers, consistent with the findings of previous reviews. Data provided by ASIC on the 17 ABA members with small business banking portfolios

(including all of the Big Four banks) shows that these ADIs had a total credit exposure of between A\$3m and A\$5m to 14,675 customers at 30th June 2020. Our analysis has also shown that approximately two-thirds of these customers would become small businesses under the Code if the aggregate borrowings limit was increased, with the other third being excluded as they have turnover above A\$10m.

Data provided by ASIC shows that, over the six quarters from 31st March 2020 to 30th June 2020, both the number of loans outstanding to customers with total credit exposure of between A\$3m and A\$5m and the average value of those loans remained roughly constant, as illustrated in the following figure.

Figure 40: Data on loans to customers with between A\$3m and A\$5m of total credit exposure



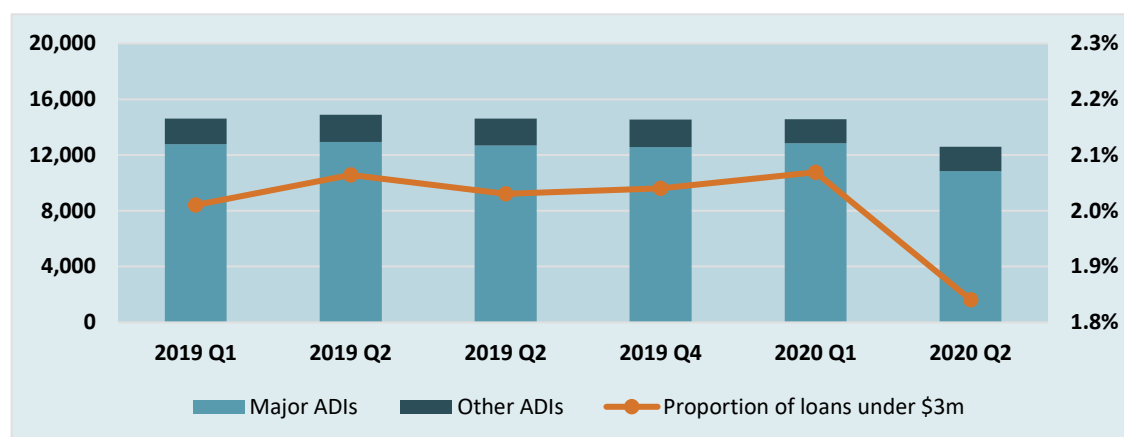
Source: Pottinger analysis of ASIC data

Out of the 19 ABA members providing data on borrowings by total credit exposure, 13 banks have also provided data based on the turnover of customers. This data covers approximately 40% of the number of loans made by Big Four banks and 68% of the number of loans made by other banks.

This data provides further useful quantification of the impact of the turnover test, at least for those banks that collect this data. Of all loans by these 13 banks to companies where the total credit exposure is under A\$3m, approximately 15,000 or about 2% are to businesses with annual turnover of A\$10m or more, ie could be excluded under the turnover test. These figures remained roughly stable over the five quarters to 31st March 2020, following which the numbers declined⁴⁵ as illustrated below.

⁴⁵ Presumably as a result of reduced turnover resulting from the economic downturn

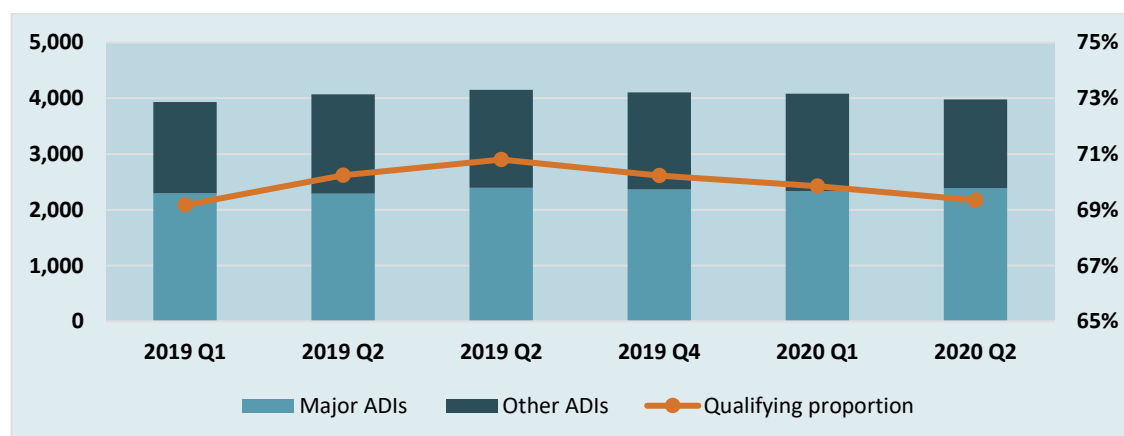
Figure 41: Loans that could be excluded by application of the turnover test



Source: Pottinger analysis of ASIC data

The data also shows that, for these 13 banks, if the borrowings criterion were increased from A\$3m to A\$5m, approximately an additional 4,000 would qualify to be treated as small business customers. This equates to approximately 70% of all loans to customers with total credit exposure of between A\$3m and A\$5m. Once again, these figures have remained approximately stable over time, as illustrated below.

Figure 42: Loans that could be included by increasing the borrowings limit from A\$3m to A\$5m



Source: Pottinger analysis of ASIC data

The impact of increasing the borrowings criterion would thus be modest, at least at the outset. As illustrated above, the number of customers impacted is of a similar magnitude to those that are impacted by application of the revenue criterion. It can thus be argued that the relative importance of the existing turnover criterion is broadly similar to the benefit of increasing the aggregate borrowing limit from A\$3m to A\$5m.

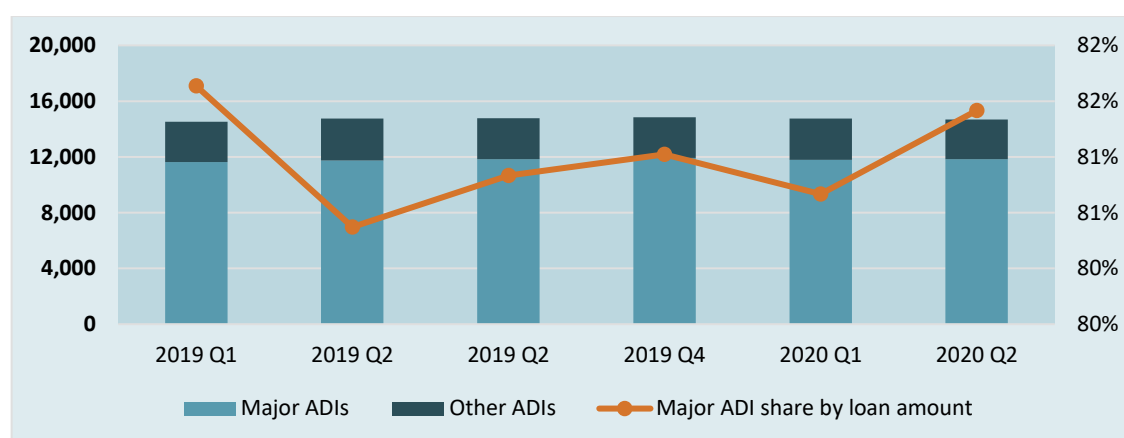
Finally, we anticipate that the number of businesses impacted by the aggregate borrowings criterion will increase over time, as companies grow in size and their borrowings increase. We note that it is possible that this could occur more rapidly in the short term, if small businesses take on additional debt as part of their response to the COVID-19 crisis and economic recession. In particular, any business that has experienced a significant drop in revenues that has material working capital requirements will need to find a way to finance its growth as economic activity begins to increase. For many small businesses, the only option will be to take on additional debt.

Accordingly, we believe that it is now a logical and opportune time to adopt the A\$5m threshold on the basis that it is applied to aggregate borrowings and is implemented in a manner that provides the banking sector with ample time for preparation.

As the impact of this change is relatively modest, we believe it is appropriate to implement this recommendation in a manner that mitigates any incremental cost and risk for banks seeking to comply with the Code. Preferably, the implementation of the requisite changes would be undertaken by large banks in a manner that enabled them to be able to adjust this limit more flexibly in the future, as it is likely that further increases will eventually be required over the medium to long term. We consider the potential timing of for implementation this change later in this section.

Meanwhile, approximately 80% of loans by number and by loan amount were accounted for by the Big Four banks. These figures have remained approximately stable over the last six quarters, as illustrated below.

Figure 43: Number of loans to customers with total credit exposure between A\$3m and A\$5m



Source: Pottinger analysis of ASIC data

In making this recommendation, we acknowledge that some banks noted the importance of adequate planning to mitigate the potential implementation cost, risk and complexity. As noted above, the overall number of businesses that would be implemented by this change is small at around 10,000 to 20,000.

Finally, we acknowledge that banks have shown flexibility in responding to the business challenges presented by the current recession. These measures include:

- Extending some benefits of the Code to businesses with up to A\$10 million total credit exposure, by agreeing not to enforce business loans for non-monetary defaults (other than as set out in para 80 the Code), up to 30th September 2020 or for the period of loan deferrals, whichever was the later; and
- Co-ordinating with APRA in relation the Australian Government's Coronavirus SME Guarantee Scheme, under which the Government provides banks with a guarantee of 50% of the amount of any new unsecured loans to businesses with a turnover of up to A\$50m.

6.5 Recommendations related to application of the criteria to groups of businesses

Recommendation 5: All three criteria should be applied at a group level

Currently, only the aggregate borrowings test is applied at a group level. There is strong support from almost all stakeholders for all three definitions to be applied in the same manner, i.e. the respective tests should take account of employees and revenues of, and borrowings by, related

business entities. We note that this approach reflects how many businesses that are part of larger groups operate day to day, where they will have access to the resources of and support from a parent and/or other related entities.

Application of all three tests at a group level would address several categories of customer identified by the ABA in its written submission as inappropriately classified as small businesses, including small operational subsidiaries of much larger organisations that collectively have low or no borrowing requirements, and/or organisations which are not financed by ‘credit providers’ but by non-bank lenders or bond holders or intra-group borrowing.

As we outline further in the following section, we also expressly recommend that the borrowings test continue to be applied at an aggregate borrowings level.

Recommendation 6: The definition of related entities should be refined

There is widespread agreement that the definition of related entities should be refined to address the various issues that we have summarised in our report. Considerable care is, however, required as to how a group of related business entities is defined, in order to avoid denying some types of organisation or structure the benefits of being treated as a small business. Conversely, large and sophisticated borrowers should not be able to design structures to create an artificial and unnecessary benefit.

Currently, the aggregate borrowing criterion takes ‘related entities’ into account based on the definition of that term set out in Section 9 of the Corporations Act 2001. Related entities include a broad set of legal and natural persons, including (by way of example) relatives, beneficiaries under a trust, trustees and related bodies corporate (ie other corporate legal entities).

The definition of ‘related entities’ does not, however, include legal entities which are affiliated or organised under certain joint venture or partnership structures, or include the legal entity of a trust itself (ie, other than the trustee or beneficiary, which are expressly included).

The use of the Corporations Act 2001 definition of ‘related entities’ thus creates two challenges.

- Certain groups of associated businesses may find themselves characterised as ‘related entities’ and thus, when taken together, exceed the borrowing limit, notwithstanding that they are businesses that should enjoy the protections of the Code. The most common example of this definitional challenge cited by regional-focussed banks consulted was agribusinesses, particularly collectives of modest, family-owned farming businesses; and
- There is inconsistent and potentially asymmetric treatment of businesses which are organised around joint venture, partnership or trust structures, even though such businesses often constitute a single economic group and have common ownership and/or shared capacity and financial resources.

We acknowledge that using the Corporations Act 2001 definition is appealing in that it ensures a common approach across many areas of business. Nevertheless, it is clear from our review that the use of this definition creates material challenges in applying the Code, particularly in the agricultural sector.

We note that taking a definitive view on this matter will require legal advice and assessment which is beyond the scope of this review. We also note that it would be preferable for any such definition to reflect as far as possible the processes used by banks in gathering data for making credit decisions, as ultimately this is where any new definition will be most heavily used.

One approach would be to adapt the definition so that it:

- Explicitly recognised unincorporated legal entities such as joint ventures, partnerships and trust structures; and

- Grouped together all businesses that are under common control.

Ultimately, any new definition should remain true to the fundamental purpose of the Code, which is to identify businesses which through their lack of scale and access to resources merit protection through simplified loan documentation, longer notice periods and greater transparency.

6.6 Recommendation related to application of the borrowings limit

Recommendation 7: The borrowings criterion should apply to aggregate borrowings at a group level, subject to revisions to the definition of related entities set out above

There is broad consensus for this approach, with almost all stakeholders expressing support.

We acknowledge that this recommendation is different from both the Khoury Review and the Hayne Royal Commission, both of which recommended that this limit should be based on the size of the individual credit facility in question.

We agree with the observation in the Khoury Review that the size of an individual facility is a better measure of the likely sophistication and complexity of documentation that might be appropriate for any particular facility. We observe, however, that the fundamental objective of the Code is to protect unsophisticated customers, rather than to require simplified lending documentation for smaller loans.

We thus believe that the focus of this criterion (and indeed the other criteria) should address the sophistication of the customer in question, rather than taking a product-centric view based on the complexity of the facility in question. This is consistent with the views of several stakeholders.

Accordingly, we disagree with basing the test on individual facility limits, as our view is that the aggregate borrowing capacity of an organisation is a better measure of its sophistication and resources than the size of any individual credit application.

A further reason for adopting this definition is that the approach recommended by previous reviews would enable large, sophisticated businesses with extensive borrowings to obtain protection under the Code for any small facility. Specifically, if the borrowing test was applied at an individual facility level, this could result in large borrowers which nevertheless had modest revenues and low employee numbers being categorised as small businesses. We believe this would create a significant issue for lenders, which would be forced to choose between lending on a 'covenant-lite' basis or potentially not advancing credit at all. In addition, and as flagged by the ABA, this would be particularly problematic for smaller banks that subscribe to the Code, for whom such lending exposures represent a proportionately larger risk.

Importantly, most small businesses (whether or not they fall within the current Code definitions) will have one primary banking relationship. In many cases, such an enterprise's borrowings will be dealt with under a single borrowing facility with a bank. Thus, there will be little or no practical difference between applying the definition at an aggregate borrowing level rather than an individual facility level for many such businesses. Conversely, larger more sophisticated businesses are more likely to have several borrowing relationships and/or facility agreements. As noted above, these more sophisticated borrowers could be inappropriately categorised as small businesses if the credit criterion was applied at an individual facility level rather than an aggregate level.

One stakeholder noted that application of the borrowings criterion at an individual facility level could encourage borrowers to seek multiple facilities from different lenders below the limit

under the ‘covenant-lite’ terms afforded by the Code, and that this could thus create a new source of risk for such customers.

Lastly, we note that in practice, most if not all banks consider an organisation’s aggregate borrowing position in considering whether or not to grant any particular credit application. As a result, the information on aggregate borrowings is readily available as part of the credit approval process. Indeed, we understand that several and potentially most banks primarily rely on the aggregate borrowings criterion in deciding whether to treat a customer as a small business and may not apply the other criteria at all.

The approach we recommend is consistent with the approach adopted by both APRA and the Reserve Bank of Australia in considering the credit exposures of ADIs and other financial institutions.

The main dissenting stakeholder views were expressed by AFCA and the BCCC. We note that, whilst the approach we recommend is not consistent with AFCA, it does not inhibit a business customer’s ability to obtain support. Thus, assuming AFCA does not evolve its own definition over time, the inconsistency between these two definitions remains in favour of the customer. We further note that one potential advantage of this approach is that AFCA’s support will be accessible by customers at the margin of the Code’s definitions, and who thus may have been denied the protections available under the Code.

6.7 Recommendation on categories of business to be excluded from the Code

Recommendation 8: Certain categories of sophisticated business should be specifically excluded from the definition of small business

The ABA has identified various categories of business which are prima facie sophisticated businesses and whose relationships are held by the institutional banking arm of banks. These customers are typically large and/or sophisticated businesses, but which due to the definition of aggregate borrowings referring to ‘credit providers’ and/or the structure of their businesses are categorised as small businesses. Examples cited include:

- Very small authorised deposit-taking institutions;
- Fund managers and funds;
- Small listed companies, which have demonstrable capability to operate under and comply with complex stock exchange listing rules and governance requirements applicable to such businesses; and
- Certain government-owned entities.

We concur with the view expressed by the ABA that such organisations should be treated as sophisticated customers and should not need the protections set out under the Code.

We note and endorse the ABA’s suggestion that a business should not be treated as a small business if: “it is a company listed on the Australian Stock Exchange, a government entity, or an Australian Financial Services Licensee that is authorised under its licence to operate registered managed investment schemes as a responsible entity or to provide custodial and depository services”.

6.8 Observations on other measures to support the impact of the Code

Measure 1: A national 'small business' labelling scheme should be introduced

One of the most significant issues raised by almost all stakeholders with whom we consulted was the confusion caused by the many different definitions of small business currently in use around Australia.

In practice, this issue cannot readily be addressed by harmonising the definitions across the different bodies, as:

- These variations reflect fundamentally different requirements of the organisations which have established them and the purposes for which they are applied;
- Some definitions may be changed at short notice, including the ATO's various definitions of small business which serve to define the availability of various tax benefits;
- Not all banks subscribe to the Code, meaning that their customers will typically not receive the benefits of the Code⁴⁶;
- In a small number of cases, an international bank's Australian subsidiary subscribes to the Code, but the Australian branch of its offshore banking entity does not⁴⁷; and
- The Code itself is rightly designed as a minimum standard for banks, many of which in practice extend the protections of the Code to a wider group of businesses.

Although almost every stakeholder urged that the many definitions of small business should be consolidated and simplified, none recommended an approach to address the challenges we have outlined above.

Meanwhile, our review identified several areas which represent, or may be perceived to represent, loopholes in the definition of small business and how this is applied by banks. These have potential to cause further confusion to customers and to create reputational risk for banks which subscribe to the Code and are thus of material relevance to the definition of small business under the Code. Examples include:

- A bank may not advise a customer as to whether or not it qualifies to be treated as a small business under the Code;
- A customer may qualify to be treated as a small business under the Code, but this status may change over time, either through its own growth, or through growth in the borrowings of a business treated as a 'related entity' under the Code⁴⁸; and
- As identified by the BCCC, a bank could adopt a broader definition of small business in determining which enterprises to treat as small businesses, but then "contend that the Code does not apply to the relevant customer in the event of a BCCC investigation".

In relation to the above issue, we note that, if a bank advises a customer that it is being treated as a small business customer, then the customer in question can rely on this status under Australian law, as otherwise the bank concerned could be accused of 'misleading or deceptive conduct'. This assumes that the customer's classification under the definition has not changed.

One particular issue is that it is not straightforward for an enterprise to determine whether or not it qualifies to be treated as a small business under the Code, as this requires knowledge of the Code, the Corporations Act 2001 definition of related entities and aspects of the Australian

⁴⁶ Banks could choose to offer the protections set out under the Code irrespective of whether they subscribe to it

⁴⁷ Large foreign banks often maintain both a locally incorporated entity as well as operating through an offshore banking entity that is authorized to operate in the country in question

⁴⁸ The customer in question may not have visibility of the performance or borrowings of such related entities

Financial Services regime. In practice, reviewing this documentation and determining its implications will not be a straightforward matter for many small businesses.

To address these challenges, an interested stakeholder or group of stakeholders could establish a nationally recognised and trademarked image to indicate that an enterprise qualified for small business protections or benefits in their dealing with the organisation in question. Relevant organisations could license this mark to use on their contracts, statements and other communications with consumers.

This would make it straightforward for any bank that wished to do so to enable their consumers to understand their protected status easily, without having to apply the relevant tests themselves, thus providing greater confidence and transparency.

With collaboration from other relevant bodies, this “P” mark could be extended to other applications, irrespective of the precise set of criteria that was used by the organisation in question to determine eligibility for small business protections and benefits.

Measure 2: ABS should provide data on businesses with between 20 and 99 employees

Many stakeholders raised the issue that it is not possible to quantify the number of legal entities (let alone groups of companies) that qualify to be treated as small businesses under the Code, or indeed under some of the other definitions in use.

In this context, we note that several definitions refer to businesses that employ fewer than 100 people, including the Code as well as those used by:

- AFCA, in determining eligibility for its small business dispute resolution process;
- ASBFEO, the Australian Small Business and Family Enterprise Ombudsman;
- ASIC, in determining whether a company is exempt from preparing and lodging a financial report and having its accounts audited⁴⁹; and
- COBA, for the Customer-owned Banking Association Code of Practice.

Currently, the ABS presents data on several categories of business, including those that employ between 20 and 199 people. We observe that it would thus be helpful if the ABS was able to present data on small businesses that differentiates between businesses that employ 20 to 99 people and those that employ 100 to 199 people.

Measure 3: ASIC should continue to collect data on small business lending by ABA members

In relation to the Code, it is also not possible to tell from publicly available data the impact of the application of the three criteria collectively, nor the potential impact of any change in the aggregate borrowing criterion from A\$3m to A\$5m.

To support this review, over the last 18 months ASIC has gathered data from relevant members of the ABA that enable precise quantification in this area. This data has been exceptionally helpful in enabling Pottinger to quantify more precisely the impact of proposed changes to the definition of small business used by the Code.

We believe it would be helpful for ASIC to continue to gather this data pending implementation of our recommendation that the borrowing criterion be increased from A\$3m to A\$5m.

⁴⁹ In some circumstances, a small proprietary company may be required to lodge financial reports

6.9 Recommendation on timing for implementation

Recommendation 9: The ABA should endorse our recommendations in the near term and implement them as soon as practicable

We note that the most recent version of the Code became effective on 1st March 2020, following a comprehensive rewriting of the Code. The scope of Pottinger's review is limited to considering the definition of small business under the Code. Meanwhile, we are aware that the Code will be subject to a wider review in 2021, which may result in further revisions being recommended.

Accordingly, we recommend that the ABA endorses the proposed changes to the Code and suggest implementation in two phases:

- Changes that are straightforward to implement, such as the proposed exclusions of certain categories of business from the Code and a shift for all three tests to be applied on a consolidated basis, could be made as part of the next update of the Code, which we understand may take place in early to mid-2021; and
- The remaining changes, including those which require further assessment (including eg legal analysis), should be implemented as part of further updates to the Code made following completion of the broader review of the Code that is to be carried out in 2021.

Significant notice should be provided to banks of the proposed date on which new provisions will become effective, in order to help minimise the cost and risk of implementing such changes.

We note that the COVID-19 crisis and subsequent significant recession in Australia has created challenging conditions for many enterprises, including small businesses. The Australian Government has provided and continues to provide considerable financial and other support to the business sector through this period and has been supported in these efforts by the banking sector, including through the ABA and its members.

Whilst we believe that the recommendations we have set out above will help to improve clarity and precision regarding the operation of the Code and will contribute to greater business confidence in engaging with Australia's banking sector, we do not regard the implementation of these recommendations as an urgent matter. Accordingly, we note and endorse the recommendation of the ABA that any changes:

"should take effect only after an appropriate implementation period to allow subscriber banks to effect changes to documentation, processes, and systems as necessary, review portfolios to identify impacted customers, and provide appropriate training to staff".

The ABA recommends a period of at least 12 months from the time of any ASIC approval of such changes, which is consistent with feedback that we have received from other stakeholders.

6.10 Implications of our recommendations

The terms of reference for our review also required us to consider the potential benefit to customers of any change in the definition of small business used by the Code, as well as any effect on the availability or price of credit to business customers as well as on competition in the banking sector. We comment briefly on these questions below.

- **Benefits to customers:** Increasing the aggregate borrowings limit from A\$3m to A\$5m would give around 10,000 business customers access to the protections of the Code. These businesses are likely to be significantly larger than the average small business that is protected under the Code. For example, their average borrowings are estimated to be around A\$3.6m to A\$3.8m based on data provided to us by ASIC. We anticipate that these businesses will thus have proportionately more turnover and employees, and as a result are

more significant enterprises in terms of their contribution to Australian economic output and employment. We consider this an important consideration as Australia undertakes to repair its industry, community and economy as a result of the COVID-19 crisis. The primary benefit for these customers will be increased confidence that they will be treated reasonably and fairly by their bank. Providing access to the Code's protections may give such customers greater confidence, and a more frictionless means, to take on additional borrowing, for example, as may be required to support business growth as the Australian economy emerges from the current recession;

- **Availability or price of credit:** There are several factors that could, in theory, impact on the availability or price of credit to business customers if the aggregate borrowings criterion is increased from A\$3m to A\$5m. These will primarily relate to a bank's assessment of the risk related to a proposed facility, or to its assessment of its ability to manage risks related to that facility over time, that may arise through the requirements imposed by the Code in relation to small business customers. In practice, a small number of banks identified that these potential risks might emerge, but we have not identified or been provided with any data or evidence through which we can quantify this risk. Ultimately, we note that the loans involved account for only a small portion of overall business lending in Australia. Our overall view is that any such risks can best be mitigated by ensuring appropriate notice is given to banks of proposed changes; and
- **Potential impact on competition:** We estimate that the value of loans that would fall within the scope of the Code if the borrowings limit was increased from A\$3m to A\$5m would be approximately A\$37bn. This equates to approximately 4.6% of all business lending in Australia by value, or 5.4% of all business lending by ABA members, or 5.8% of all business lending by ABA members with small business lending portfolios. In other words, the proportion of the business lending sector that would be affected by these changes is small.

Overall, as the size of the proposed changes is modest set against the context of banks' lending activities, we believe there is unlikely to be any material impact on ongoing competition in the provision of loans to small business as a result of these changes. Further detail is set out in section 2.5 (The extent and nature of companies impacted by these definitions).

6.11 Alignment with other definitions of small business

As noted above, though almost all stakeholders have advocated strongly for simplification, we cannot see any practical way in which the many different definitions of 'small business' employed across the Australian business landscape can be consolidated into a single definition. We have suggested that the introduction of a national labelling scheme by an interested stakeholder or group of stakeholders could help to address this issue.

Meanwhile, we have also considered what benefit might result from alignment with the definitions of small business adopted for the jurisdiction of:

- AFCA – under 100 employees and an individual facility limit of A\$5m;
- ASBFEO – under 100 employees and a turnover limit of A\$5m; and
- ASIC's internal dispute resolution guidance⁵⁰ – under 100 employees (if the business manufactures goods or includes the manufacture of goods) or 20 people otherwise. This will change to align to the AFCA definition of 100 employees in October 2021 when RG 271 Internal Dispute Resolution⁵¹ becomes effective.

⁵⁰ Regulatory Guide 165, RG 165.69, available from this link

⁵¹ Regulatory Guide 271, RG 271.37 available from this link

Overall, we concluded that it is not appropriate to amend the values used in the Code's definitions to match the above, as:

- Adoption of an individual facility limit, rather than an aggregate borrowings limit, would reflect a product-centric approach rather than a customer-centric approach. We believe the latter is more appropriate given the overall objectives of the Code; and
- Reducing the turnover limit to A\$5m would result in a significant number of companies that currently benefit from the Code being excluded.

Importantly, AFCA's definition results in more companies being eligible to access its services than qualify as small businesses under the Code. This is prospectively helpful, in that AFCA's support is available to companies whose dispute may in part relate to the basis on which they have been excluded from the protections available to small businesses under the Code.

6.12 Conclusion and acknowledgements

Overall, we believe our recommendations reflect a broad consensus across most relevant stakeholders and are designed to:

- Increase consistency and clarity regarding which businesses are treated as small businesses, by improving the precision of the definition of small business;
- Enhance the confidence of small businesses in the banking system, by providing greater transparency regarding the status of their banking relationships;
- Align with business and banking practice as to how business is done with groups of companies; and
- Address the concerns of some stakeholders related to the cost, difficulty and risk of implementing the proposed changes.

In concluding, we would like to express our appreciation to the government bodies, companies, small businesses and individuals who contributed to our review. Each conversation and submission has provided useful information and perspective and we appreciate and acknowledge the time that you have each taken to provide your input.

7. Index to figures

Figure 1:	Overview of stakeholders consulted	5
Figure 2:	Proportion of businesses with revenues in the band indicated	5
Figure 3:	Summary of recommendations	7
Figure 4:	Summary of our responses to the questions raised in our terms of reference	9
Figure 5:	Examples of definitions of "small business" currently in use in Australia (axes not to scale)	11
Figure 6:	Questions to be addressed by Pottinger's independent review.....	14
Figure 7:	Specific matters to be addressed by Pottinger's Independent Review	15
Figure 8:	Proportion of businesses with employees employing up to the number of employees stated	15
Figure 9:	Proportion of businesses with revenues in the band indicated	16
Figure 10:	Definitions of small business in common use in Australia.....	16
Figure 11:	Definitions of small business applied by the States and territories.....	18
Figure 12:	Current members of the ABA	18
Figure 13:	Proportion of the Australian banking system covered by the Code	19
Figure 14:	Proportion of Australian business lending by ADIs covered by the Code.....	19
Figure 15:	Number of loans with total credit exposure between A\$3m and A\$5m and average loan value..	20
Figure 16:	Share of loans where total credit exposure is between A\$3m and A\$5m	21
Figure 17:	Number of loans where data on turnover of borrowers is available (13 banks)	21
Figure 18:	Number and proportion of businesses excluded by application of the turnover test (13 banks) ..	22
Figure 19:	Number of loans to customers with total credit exposure between A\$3m and A\$5m (13 banks)	22
Figure 20:	Number of additional enterprises that would qualify as small business customers (13 banks)	23
Figure 21:	Impact of increasing the aggregate borrowings limit from A\$3m to A\$5m (all ABA members)	23
Figure 22:	Comparison of impact of revenue test with increase in borrowings limit (13 banks).....	24
Figure 23:	Estimation of average size of loans included by increasing the borrowings test to A\$5m	25
Figure 24:	Estimation of value of loans included by increasing the borrowings test from A\$3m to A\$5m	26
Figure 25:	List of stakeholders consulted directly	28
Figure 26:	The Code's Statement of Guiding Principles.....	29
Figure 27:	Overview of the scope of the Code (not to scale)	30
Figure 28:	OECD Monthly Business Confidence Survey – year 2000 to date.....	31
Figure 29:	List of ABA members by total assets at 31 st August 2020.....	32
Figure 30:	Categories of financial product under Australia's financial services licencing regime	33
Figure 31:	Criteria used in the definition	35
Figure 32:	Approach to definition of small business in other jurisdictions	36
Figure 33:	Low margin businesses – bottom twenty sub-sectors in 2019 (bottom quartile)	37
Figure 34:	Employment intensity of low margin businesses ranked by EBITDA margin (low to high)	38
Figure 35:	Composition of businesses with employees by size	39
Figure 36:	Relative significance of requirements imposed on banks from different sources	42
Figure 37:	List of stakeholders consulted directly	46
Figure 38:	Public questionnaire – background information provided	52
Figure 39:	Definitions of small business in common use in Australia nationally	57
Figure 40:	Data on loans to customers with between A\$3m and A\$5m of total credit exposure	59
Figure 41:	Loans that could be excluded by application of the turnover test	60
Figure 42:	Loans that could be included by increasing the borrowings limit from A\$3m to A\$5m	60
Figure 43:	Number of loans to customers with total credit exposure between A\$3m and A\$5m.....	61