Business groups and the Banking Code

The Australian Banking Association's (ABA's) Banking Code of Practice (the Code) is the first substantive industry code of practice to be approved by the Australian Securities and Investments Commission (ASIC).

An important item in the Code is the definition of 'small business'. This definition determines the extent to which the Code applies to businesses. In approving the Code, ASIC required the ABA commission an independent review of the definition of small business. In 2020 the ABA requested the consultancy firm Pottinger to undertake this review.

The Pottinger Review made important recommendations for changes to the definition including an increase in the 'total credit outstanding' criterion from $3 million to $5 million. That and other recommendations have been accepted by the ABA and will be given effect in the next edition of the Code following the Independent Review of the Banking Code.

The Pottinger Review also recommended changes to how the Code describes business groups, after questioning the adequacy of the use of the term 'related entities'. The ABA committed that this question would be addressed in conjunction with the Independent Review.

Due to the technical legal nature of this question, this issue is being addressed by legal experts commissioned by the ABA, rather than by the independent reviewer (Mike Callaghan).

This paper has been prepared on behalf of the ABA for this purpose by King & Wood Mallesons, Level 50, Bourke Place, 600 Bourke Street, Melbourne VIC 3000.

The ABA now invites comments on this paper prior to finalising any changes to the way the Code defines business groups.

Submissions will be accepted until 28 February 2022 and should be addressed to: submissions@bankingcodereview.com.au

Pottinger Recommendations

Pottinger released its review "The definition of "small business"" on 26 October 2020 (the "**Pottinger Review**"). In the ABA response of 13 November 2020, the ABA agreed with the recommendations in the Pottinger Review.

The Pottinger Review considered the Code's tests for whether a customer is a "small business" in the March 2020 Code release. That test treated a customer as a "small business" on the basis of three criteria: annual turnover, employee numbers and total debt. Annual turnover and employee numbers were assessed on an individual customer basis. Total debt was assessed by looking at the aggregate total debt of the customer and related entities.

The March 2021 release of the Banking Code amended that test so that annual turnover and employee numbers were assessed on an aggregate basis by looking at the customer and related bodies corporate on the basis of Corporations Act s 50.

The Pottinger Review recommended that all three of the criteria be applied on an aggregate basis, but was critical of the use of "related entities" as a mechanism for determining which entities are within the aggregation group. The Pottinger Review recommended "*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*".[1]

The Pottinger review also found that:[2]

[1] Pottinger Review p 8.
[2] Pottinger Review p 40, 62

a) Adopting the Corporations Act "related entity" concept within the Banking Code requires readers of the Banking Code to also understand the Corporations Act definition, together with other definitions, in a way which is complex and uncertain;

b) The Corporations Act definition of "related entity" is in some ways too narrow, as it does not include entities such as joint ventures, partnerships, trusts and other entities that are part of large, sophisticated groups. This means that these entities are not appropriately excluded from the Banking Code;

c) The Corporations Act definition of "related entity" is in some ways too broad, as it includes entities that are not under common control or operating as a single operating entity, such as businesses owned by members of an extended family – the particular example given is collectives of family-owned farming businesses;

d) There is broad support for the definition of "small business" to remain as simple as possible.[3]

The Pottinger Review concluded that specific legal advice should be obtained in revising the definition of "small business", and noted that "*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*".[4]

The Pottinger Review also recommended that certain categories of sophisticated business should be specifically excluded from the "small business" test entirely, without reference to any of the above "small business" criteria.[5]

This paper considers how to redraft the definition of "small business" to avoid using the term "related entity", and to better capture the entities that the Pottinger Review thought should be included in the aggregation group.

Practical issues

The various aims in the Pottinger recommendations are not always easy to reconcile. A broad principles-based approach may provide a definition that is short and easy to comprehend in the abstract but is difficult to apply to particular situations. A specific and detailed definition may provide more specific clarity but will be longer and provide less guidance when a situation that is not specifically dealt with arises. The use of developed concepts from other areas such as the Corporations Act or accounting standards may provide clarity, but this requires readers to be familiar with the relevant concepts.

Any test based on a concept of "control" requires a decision to be made about what constitutes control. A test that looks at actual ability to control is likely to best reflect the ideal policy goal of the Banking Code, but may be difficult to apply in practice because it requires a full understanding of how the relevant entity actually operates. Alternatively, a test might simply look at signifiers of control, and aggregate entities on the basis of, for example, a 50% or a 30% shareholding as a proxy for actual control. This sort of test may be easier to apply in practice, but is ultimately arbitrary, and so may include entities that would be excluded by an in-substance test (and vice versa).

An approach that favours a more specific list of different situations over a broad principles-based approach – such as "control" – runs into the problem that there are many potential scenarios and combinations of business structures which the test needs to address.

Any revised drafting of the "small business" test is going require balancing these issues, and there is likely no perfect solution. To assist ABA members in making a decision, we have prepared two

[3] Pottinger Review p 53.
[4] Pottinger Review p 8.
[5] Pottinger Review Recommendation 8.

alternative drafting suggestions, and set out what we see to be the perceived advantages and disadvantages with each.

Proposed amendment to definition

Amendment to definition

Incorporating the outstanding changes recommended by Pottinger, and those proposed in this paper, would result in the following amendments to the current definition of small business in the Code:

> **What is a "small business"?**
> A business is a "small business" if at the time it obtains the banking service all of the following apply:
>
> a) it had an annual turnover of less than $10 million in the previous financial year*; and
>
> b) it has fewer than 100 full-time equivalent employees*; and
>
> c) it has less than $5 ~~3~~ million total debt (excluding debt to which the NCC applies) to all credit providers — including:
>
> i. any undrawn amounts under existing loans; and
> ii. any loan being applied for; ~~and~~
> ~~iii. the debt of all its related entities that are businesses.~~
>
> However, a business is not a "small business" if it is a company listed on the Australian Stock Exchange, a government entity, a partnership or joint venture with more than [*X – feedback sought on appropriate number*] partners or venturers 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.
>
> * Note: Where a business is part of a business group, this test may be applied on the basis of the aggregate turnover, employee numbers and debt of the business group.
> [*Insert "business group" option from Option 1 or Option 2 below*.] ~~If the business is part of a group of bodies corporate (see s. 50 Corporations Act), paragraphs (a) and (b) are assessed on the basis of the group.~~

Discussion

Most of these amendments reflect the Pottinger recommendations.

The specific reference to the National Credit Code (NCC) is not a change to the test, but rather is an insertion to make the "small business" definition easier to understand as a self-contained definition. The Banking Code definition of "business" also includes this exclusion of National Credit Code debt, but feedback from some of the ABA members suggests that having to refer back to the "business" definition made the "small business" test harder to understand.

We have then provided two options for how a business group is determined, set out below.

Australian Banking Association

Business Group Option 1 – Control based (Corporations Act or Accounting Standards

Drafting proposal

> A business group includes an entity (the "controlling entity") and all entities that [we reasonably consider] are controlled by the controlling entity (regardless of whether the customer is a controlled entity or is the controlling entity), where "control" has the meaning given in Corporations Act s 50AA.

The intention behind this option is to provide a short statement that is easily understandable at a general level, and sets out a general principle for determining who is in a business group.

Any test based on the principle of control will need to establish how control is determined. The above drafting adopts the existing Corporations Act s 50AA test. The Corporations Act s 50AA test looks at the capacity of one entity to determine the outcome of a second entity's decisions about financial and operating policies. It looks at practical influence rather than strict legal rights, and takes into account practices and patterns of behaviour.

Alternatives might be Accounting Standards based tests, such as looking at whether the entities were grouped and submitted consolidated accounts, or were "related entities" under AASB 124.

Advantages

The advantage of this option is that it is short, and provides a principles-based control test that reflects the Pottinger Review recommendation. This control test does not look at structure, and so applies to all business structures and combinations of structures.

The drafting does adopt the Corporations Act concept of control, and so requires readers to be familiar with the Corporations Act concept. However, the Corporations Act concept of control is well established. It is also based on the practical capacity of an entity to determine the decisions made by another entity, and so is likely to largely reflect the normal community understanding of the word "control".

A separate plain English definition of in-substance control based on the Corporations Act could be drafted and inserted into the Banking Code, which would avoid the need for familiarity with the Corporations Act concept. However, this would then be a new test that would not have the Corporations Act test advantage of being well established and understood. It might also create a situation where there would be an expectation that the Corporations Act and Banking Code tests were substantially the same, but where differences in wording actually created different outcomes.

Disadvantages

The Corporations Act control test is ultimately a factual test. It looks at the actual practical ability of one entity to determine the decisions made by another entity. To apply this sort of test requires a full understanding of the situation of the individual customer, and the test does not permit reliance on normal signifiers of control without enquiry.

For example, a company may have one majority shareholder and one minority shareholder. A review of the share register would then suggest that the majority shareholder controls the company. In fact, the minority shareholder may actually control the company through force of personality or by an undocumented arrangement or understanding with the majority shareholder. However, this would not be readily apparent without detailed factual enquiry. This sort of detailed enquiry may be time consuming and expensive, and so would create practical difficulties in the application of the "small business" test. A similar problem arises with the AASB 124 related entity test.

This problem could be reduced to some extent by allowing the bank to act on the basis that it "reasonably considers" one entity to control another, but this may be seen as the banks imposing their own subjective views on the test, and may lead to the test being applied in different ways by different banks.

The problem could also be reduced by specifically allowing banks to rely on a customer's self-declaration about control. However, this is not done elsewhere in the Banking Code, and could be viewed as providing a route for small business customers to be asked to contract out of the application of the Banking Code. It may be criticised as contrary to the aims of the Banking Code.

These same issues would apply to any attempt to draft a plain English version of the Corporations Act control test for the Banking Code.

Business Group Option 2 – Control based (deemed control)

Drafting proposal

For a customer, a business group consists of the customer and:

a) Each entity the customer controls;

b) Each entity which controls the customer;

c) Each other entity which is controlled by an entity referred to in (b).

For this test, an entity includes a natural person, a company, a trust, a partnership and a joint-venture.

An entity controls another entity if:

i. It is a director or trustee of the entity;

ii. it is a partner or joint venturer in the entity, and there are no more than [*X – feedback sought on appropriate number*] partners or joint venturers in that entity; or

iii. otherwise, it has a shareholding, unit holding, partnership, joint-venture or other interest in the entity of [50%] or greater.

Control includes direct control, and indirect control through other controlled entities.

Where the customer consists of more than one entity – for example, joint borrowers or joint account holders, the customer business group consists of all those entities, and each other entity that would be included in the customer business group for any of them.

Similarly to Option 1, this option operates on a general control concept. However, in this option control is designated by the specific size of a participant's interest in the venture, not actual control.

Advantages

This option provides a more concrete and specific approach than Option 1.

While the test specifically refers to companies, trusts, partnerships and joint ventures, the use of inclusive terms like "entity" and "interest" provide some principled basis for other unanticipated business structures.

The test relies on percentage shareholding or other interest, and the partnership / Joint venture size, as facts that trigger deemed control. A final decision will need to be made as to where to set these requirements. The draft proposes a 50% shareholding, and a partnership / joint venture of 20 people or less as a starting point for this discussion.

The test would create different outcomes to the Corporations Act control test, but this is immediately apparent from the criteria used in this test, and so there would be no expectation of identical outcomes.

Disadvantages

This option requires the reader to work through the various different elements. However, this is a disadvantage that will apply to any approach that does not rely on an Option 1 type of general test of control. This option attempts to provides a relatively short and intuitive approach to that exercise. Because a deemed control test is necessarily arbitrary, this option has the following limits:

a) Aggregation does not apply on the basis of familial relationships.

b) The test treats percentage shareholding, partnership and joint venture participation in small partnerships or joint ventures, and director or trustee status as proxies for control. This is to create a "bright line" test for control that is easy to apply, without having to conduct a difficult assessment of actual control. The disadvantage of this sort of bright line test is that it may allow aggregation in situations where the aggregated entities are not really part of a common enterprise and where the control test in Option 1 would not allow aggregation.

c) For example, the director limb effectively treats each individual director as a separate "controlling entity" (noting that the current "related entity" test in the Banking Code does this as well). This allows a broader scope of aggregation than the control test in Option 1. If a person is a director of the borrower and 2 other companies that have nothing else in common, those three companies are still aggregated for the test even though it is likely they are independent businesses. Similarly, if 3 directors of a borrower company all have separate business borrowings for separate business ventures of their own unrelated to the company, these will be included in the aggregation, even though the directors do not control each other. The current "related entity" test has the same result. One alternative might be to limit aggregation to companies that have a majority of common directors (bearing in mind that the shareholding test may then separately apply to aggregate companies with an individual common director). Another alternative would be to exclude the separate debt of directors for businesses unrelated to the company. However, there will be situations where both of these alternatives then exclude aggregation that the "control" test might include. Treating every director as a potential "controlling entity" is at least a simple test that is easy to apply, even if it is potential broad.

d) In relation to shareholding, an alternative test might be to look at the ability to appoint a director or a majority of directors rather than on a percentage shareholding, but this sort of more detailed factual test will have the same problems as discussed in Option 1.

e) Partnerships and joint ventures are currently included on the basis of the absolute number of partners or venturers. An alternative would be to base the test on partnership or joint venture share, but this might require analysis of a partnership or joint venture agreement. Feedback from members is that this may be difficult to assess for partnership arrangements that are informal or not extensively documented.

This part of the test is also limited to small partnerships and joint venturers. Below the threshold size, all partners and joint venturers are deemed to have control. Above the threshold size, no partner or joint venture is deemed to have control (unless they satisfy the (iii) "other interest" test). Again, this is on the basis that the certainty provided by a bright line test is preferable to a more nuanced test that is harder to apply in practice.

One result of this is that where the borrower is a small partnership, the separate business debt of partners may be included. However, where the borrower is an individual who happens to be a partner in a small partnership, the debt of the partnership may be included, but not the separate debt of other partners.

Joint customers

Where there are joint customers, this clause specifically permits aggregation. So for example, if a loan agreement has 2 co-borrowers, the aggregation involves those two borrowers, and any other entity that could be aggregated with either borrower on its own.

The Khoury Review expressed some concerns about loans structured as co-borrowing, but co-borrowing is now regulated under Banking Code section 53-57 where it relates to individual co-borrowers.

A similar joint customer mechanism could be applied to the other options as well.

Preliminary conclusion

Initial industry feedback has indicated that an Option 1 type approach based on the actual ability of one entity to control another will create considerable practical difficulties, and may result in higher costs, longer processing times and more invasive information requests for customers.

An Option 2 type approach would be easier to apply in practice and provide clearer outcomes for banks and their customers, accepting that the "bright line" approach may result in outcomes that do not always reflect actual control.