



Australian Business Growth Fund

Australian Government Competitive
Neutrality Office

Investigation no. 17

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23 December 2021

The Hon Josh Frydenberg MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with section 21 of the *Productivity Commission Act 1998* and the Commonwealth Competitive Neutrality Policy Statement, I have pleasure in submitting the results of the Australian Government Competitive Neutrality Complaints Office's investigation of the Australian Business Growth Fund.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'S King', written in a cursive style.

Dr Stephen King
Commissioner
Competitive Neutrality Complaints

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Competitive neutrality policy

Competitive neutrality is a policy which aims to promote efficient competition between public and private businesses. The Australian Government's approach is set out in its *Competitive Neutrality Policy Statement* (Australian Government 1996):

Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership (p. 4).

In particular, competitive neutrality policy:

... requires that governments should not use their legislative or fiscal powers to advantage their own businesses over the private sector (p. 5).

While the policy recognises that there are a number of advantages and disadvantages of government ownership, it does not seek to ameliorate all of these. Instead, it focuses specifically on those competitive advantages enjoyed by government businesses that are widespread and relatively easy to observe and correct (Australian Government 1996, p. 6), including:

- exemptions from various taxes (taxation neutrality)
- access to borrowings at concessional interest rates (debt neutrality)
- exemptions from complying with regulatory arrangements imposed on private sector competitors (regulatory neutrality)
- other benefits associated with not having to achieve a commercial rate of return on assets (commercial rate of return requirements).

The policy is applied to significant government businesses where the benefits from doing so outweigh the costs. For the purpose of competitive neutrality policy, a business activity is defined as one where:

- there is user charging
- there is an actual or potential competitor (that is, users are not restricted by law or policy from choosing alternative sources of supply)
- managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is provided.

Competitive neutrality policy deems the following organisations as significant as they have been specifically structured to operate along commercial lines:

- all government business enterprises (listed under the *Commonwealth Authorities and Companies Act 1997*) and their subsidiaries
- other share limited trading companies
- all designated business units.

Other activities which operate in accordance with the definition of a business and generate in excess of \$10 million in revenue from commercial activities are also considered to be significant.

Overview

In late 2020, the Australian Government Competitive Neutrality Complaints Office (AGCNCO) received a complaint from OnMarket BookBuilds Pty Ltd relating to alleged breaches of competitive neutrality connected with the Australian Business Growth Fund (ABGF). Launched in 2020, the ABGF is a private company that seeks to provide 'patient capital' to small and medium-sized businesses. The Australian Government is a minority shareholder alongside a number of major financial institutions. That part-ownership is sufficient to render the fund subject to competitive neutrality policy.

Among other matters, the complainant alleged that under the direction of the Australian Government, the Australian Prudential Regulation Authority (APRA) lowered the capital adequacy requirements that would normally apply for investments made by authorised deposit-taking institutions (ADIs) in an equity fund with a structure and investment profile similar to the ABGF. The complainant's concern was that this reduced the cost of capital for the ABGF relative to other financial entities competing in the same market (namely, the market for providing equity finance to small and medium-sized businesses) and provided the fund with a substantial competitive advantage.

The core of the complaint is that APRA changed the capital adequacy requirements for ADIs investing in the fund because of the Australian Government's part-ownership of the fund, rather than because of the inherent riskiness of investments in the fund. If true, this would be contrary to the principle of regulatory neutrality, which requires that government businesses are not exempt from complying with regulatory arrangements imposed on private sector competitors.

The AGCNCO's approach is to assemble all available evidence and make the assessment of a potential breach on the balance of probabilities (though it should be emphasised that the AGCNCO is not a court and that it is up to the Australian Government whether it wishes to accept the Office's findings or recommendations). During this investigation, the AGCNCO held discussions with the complainant, APRA, the ABGF and the Treasury. It also sought information from the United Kingdom Prudential Regulation Authority on a similar growth fund that does not have any government involvement. The AGCNCO requested access to documents held by APRA, the ABGF and the Treasury, and both the complainant and APRA provided public statements on matters relating to the investigation. The AGCNCO has also drawn on other evidence, including the Basel III framework and the capital adequacy decisions for comparable growth funds in the United Kingdom and Canada.

In response to questioning, APRA reported that the capital treatment for investments made by ADIs in the fund was not based on its part-ownership by the Australian Government. APRA stated that it provisionally developed the treatment of investments in the ABGF on 27 November 2018. Although the Australian Government had committed to support the fund, there is no evidence that it had, at this stage, indicated that it would adopt an ownership stake. APRA claimed that they were not aware of the Australian Government's intention to hold equity in the fund until the Government announced it would do so on 23 April 2019, and that the capital treatment was unchanged between 27 November 2018 and 9 December 2019, when the treatment was announced — both points are consistent with the view that Government ownership did not affect the capital treatment.

Further, the capital adequacy requirements put in place are broadly consistent with (although not identical to) the internationally-agreed Basel III capital framework. Similar growth funds operating in the United Kingdom (UK) and Canada are also subject to comparable (and at times more generous) capital adequacy requirements, without government shareholding.

Like the growth funds in the UK and Canada, Australian Government support for the fund's development was a key factor in the creation of the fund, and for APRA's decision about its capital treatment. However, the capital adequacy rules applied to ADI investments in the ABGF appear to be reasonable, based solely on the fund's design. Further, the timing of APRA's decisions mean there is no evidence that government *shareholding* (as distinct from government *support*) influenced APRA's decision to provide this special treatment. Thus, on the balance of probabilities, this regulatory treatment cannot be attributed to the presence of the Australian Government as a part owner of the fund.

In that context, the AGCNCO finds that the capital treatment of investments in the ABGF does not represent a breach of the Australian Government's competitive neutrality policy.



Finding 1

The risk treatment afforded by the Australian Prudential Regulation Authority to investments made by authorised deposit-taking institutions in the Australian Business Growth Fund, in which the Australian Government is a minority shareholder, does not constitute a breach of regulatory neutrality under the Australian Government's competitive neutrality policy.

Even though the regulatory treatment of the ABGF is not a direct result of Australian Government's shareholding, the treatment is currently only available to investments in the ABGF. This could create an appearance that the regulatory treatment is exclusive to investments in a fund involving some level of government ownership. In its discussions with the AGCNCO, APRA indicated that it would assess whether investments in any other proposed fund would be eligible for similar capital treatment, but that the same treatment would not be available automatically. Lack of clarity about the circumstances for equivalent treatment could act as a barrier to the development of any competing equity fund.

To remove the notional exclusivity of the capital adequacy test for ADI investments in the ABGF, APRA could publicly provide greater specificity about the circumstances in which investments by ADIs in any competing fund would be eligible for the same capital treatment as investments in the ABGF.



Recommendation 1

To remove any appearance of exclusivity of the capital adequacy test for investments by authorised deposit-taking institutions in the Australian Business Growth Fund, the Australian Prudential Regulation Authority could provide greater specificity about the circumstances in which investments by ADIs in any competing fund would be eligible for the same capital treatment.

Finally, this investigation raised some challenging issues in assessing a potential breach of competitive neutrality policy for joint ventures like the ABGF. The ABGF is only partly owned by the Australian Government, rather than being a standalone government business, which is a more typical target of concerns about competitive neutrality. Assessing and remedying any breach of competitive neutrality in a business only partly-owned by government involves additional complexities, which accentuates the imperative for close scrutiny of such arrangements before their establishment, as well as a high standard of transparency to avoid the risk of raising competitive neutrality concerns after the fact.

Clearer guidance on this could be developed as part of Treasury's Competitive Neutrality Review, which has yet to finalise its deliberations and release its report.



Finding 2

Assessing and remedying a breach of competitive neutrality may be more difficult for a partly owned government business than one fully owned by government. This increases the imperative for a careful and transparent assessment of competitive neutrality prior to government becoming a part owner of a business.

1. About the complaint

In late 2020, the AGCNCO received a complaint by OnMarket BookBuilds Pty Ltd relating to alleged breaches of competitive neutrality connected with the Australian Business Growth Fund (ABGF). Launched in 2020, the ABGF is a company that provides 'patient capital' to small and medium-sized enterprises (SMEs). The Australian Government is a minority shareholder alongside a number of major financial institutions.¹ This chapter outlines the nature of the fund and the complaint, and the role of the AGCNCO in investigating the complaint.

The Australian Business Growth Fund

The Australian Government established the ABGF in October 2020 to provide equity finance to SMEs. Shareholders have initially committed to contribute \$540 million to the fund: this consists of commitments of \$100 million from the Australian Government,² ANZ, the Commonwealth Bank, the National Australia Bank and Westpac, alongside \$20 million each from HSBC Australia and Macquarie Bank.

The investment aims of the ABGF are to:

- increase the availability of patient capital to Australian SMEs
- increase the level of investment in SMEs across Australia
- facilitate interstate and overseas trade and commerce
- support job creation and economic growth in response to the COVID downturn. (Frydenberg 2020)

The ABGF will invest in established Australian headquartered SMEs with three consecutive years of profitable operations, a clear growth strategy and annual turnover between \$2 million and \$100 million (ABGF 2021; Frydenberg 2020). As at 15 December 2021, these criteria were still in place.

Investments 'must be commercially viable and make a return appropriate to the underlying risk of the investment' (Frydenberg 2020). Further, the ABGF will only assume a minority non-controlling stake typically between 10 and 40 per cent (but up to 49 per cent) of share capital in those businesses. Shareholders anticipate expanding the fund to \$1 billion, with a requirement that there be a spread of investments across industries and regions (Frydenberg 2020). The fund is similar in design to business growth funds in the UK and Canada — although these funds have no government shareholding.

Notwithstanding the Australian Government's shareholding, the ABGF is constituted as a private business. As a result, there is limited public information concerning the fund's investment mandate, and the

¹ The ABGF should not be confused with the Business Growth Fund, which is a grant program for small business run by the Queensland Government.

² The Australian Government has so far contributed \$2 million to the fund, with plans to contribute a further \$9.53 million in 2021-22 (Commonwealth of Australia 2021).

shareholder agreement made in establishing the fund has not been published (Senate Economics Legislation Committee 2020a, p. 30).

Nature of the complaint

In December 2020, the AGCNCO received a complaint regarding the ABGF. The complainant, OnMarket BookBuilds Pty Ltd, is an equity-raising platform that provides finance to a range of businesses, including SMEs.

The complaint raised four concerns about the design and operation of the ABGF, namely that:

1. the 'Government caused its agency, APRA, to change prudential regulations for the purpose of lowering the cost of capital supplied by bank shareholders to the ABGF ... lowering the ABGF's cost of capital to a fraction of the commercial cost of capital of competitors ... [and providing] ... an unassailable competitive advantage in the market for financing equity investments in SMEs' (OMBB 2020, p. 1). The complaint further noted that '... but for the Government's shareholding, APRA would not grant this new prudential concession' (OMBB 2020, p. 4). This was seen as contravening competitive neutrality policy.
2. APRA did not consider competitive neutrality when making this regulatory change, despite their apparent requirement to do so under section 8(2) of the *Australian Prudential Regulation Authority Act 1998* (Cth) (APRA Act)
3. the fund breaches provisions of the *Competition and Consumer Act 2010* (Cth), including prohibitions against: cartels (ss. 45AF-45AG), arrangements that have the purpose or effect of substantially lessening competition (s. 45) and misuse of market power (s. 46)
4. the fund is invalid under the Australian Constitution.

Of these, (3) and (4) are outside of the remit of the AGCNCO. (However, the AGCNCO notified the Australian Competition and Consumer Commission of the allegations concerning potential breaches of the Competition and Consumer Act.)

Claim (1) squarely falls under the scope of the AGCNCO, while (2) has potentially indirect relevance. Whether APRA adequately considered its competitive neutrality obligations under section 8(2) of the APRA Act is not per se a question directly relevant to the existence of a breach. Although AGCNCO has discussed this question below, it makes no finding in respect to this matter.

What did APRA do?

In December 2019, APRA adjusted its capital framework for ADIs³ to allow those that invest in the ABGF to apply a risk weight of 250 per cent to that investment, compared with the usual treatment of a full deduction from Common Equity Tier 1 (CET1) capital. (The details of this adjustment are outlined in box 1.)

³ ADIs are financial entities licenced by APRA to carry on banking business, including accepting deposits from the general public. They include banks, credit unions and building societies. To maintain the financial soundness of individual institutions, as well as the stability of the financial system, ADIs are required to hold a minimum amount of capital relative to the size and risk of their lending and investment activities.

Box 1 – What treatment did APRA provide to investments in the ABGF?

To minimise risks to the stability of the financial system, APRA requires ADIs to hold a specified capital reserve (regulatory capital). This reserve is designed to ensure that the ADI can absorb potential losses, such as loan defaults, without jeopardising the broader system. The amount (and type) of regulatory capital that an ADI must hold depends on the amount (and type) of an ADI's liabilities — riskier investments generally require ADIs to hold larger reserves.

One prudential capital requirement is the ratio of Common Equity Tier 1 capital reserves (CET1; the most secure type of capital reserve) to total risk-weighted assets held by an ADI. If an ADI makes an equity investment, APRA generally requires a full deduction from their CET1 regulatory capital reserves, requiring a bank to hold an equivalent amount of CET1 capital to maintain the prudential capital ratio. That is, in normal circumstances, for every dollar a bank invested in an equity product it would be required to hold a dollar in its liquid capital reserve. This treatment reflects a principle that equity risk should be fully borne by an ADI's shareholders, rather than depositors or other creditors.

An ADI must maintain a CET1 ratio of 10.5 per cent to meet the capital requirement associated with APRA's implementation of the 'unquestionably strong' framework (APRA 2017). Without special treatment, this ratio means that an equity investment is effectively subject to a 952 per cent risk weighting. This is the weighting consistent with a requirement that every dollar of equity investment be matched by an increase in CET1 of a dollar.

On 9 December 2019, APRA issued a letter to all ADIs notifying them that any investments they make in the ABGF would receive revised treatment compared with other equity investments. Investments in the ABGF are instead subject to a risk weight of 250 per cent and, to manage risks from the lower reserve requirement, the amount that can be invested in the ABGF is limited to 2 per cent of the ADI's CET1 capital holdings.

A risk weight of 250 per cent significantly reduces the amount of additional CET1 capital required to be set aside to meet the required capital ratio. With a CET1 ratio of 10.5 per cent, an investment with a risk weight of 250 per cent requires an ADI to only set aside 26.25 per cent of the investment value as CET1 capital. Accordingly, the opportunity cost of undertaking an investment in the ABGF using the revised prudential treatment is considerably less than under the default treatment, making such investments more appealing for ADIs compared with alternatives. However, a 250 per cent risk weighting is still higher than many other potential investments, such as an unsecured small business loan (100 per cent risk weighting).

Source: APRA (2019a, 2019b, p. 11); PC (2018); AGCNCO estimates.

Jurisdiction of the AGCNCO

Is the ABGF subject to competitive neutrality policy?

In the first instance, there is a threshold question over whether the ABGF, as a private fund, is subject to the Australian Government's competitive neutrality policy and, as a consequence, subject to the Government's competitive neutrality complaints mechanism.⁴

In accordance with the Australian Government's 1996 *Competitive Neutrality Policy Statement*, competitive neutrality policy will apply to 'significant government business activities' (Australian Government 1996, p. 7). The policy provides guidance on what constitutes a *business*, a *significant activity*, and a *government activity*.

Under the policy guidelines, the ABGF clearly constitutes a *business*, and is of a scale to be considered as a *significant activity*. On the matter of whether the Australian Government's partial shareholding in the ABGF is sufficient to qualify it as a *government activity*, the 1996 policy does not specify how this is determined. It does, however, note that 'Commonwealth share-limited companies are generally expected to comply with all competitive neutrality requirements' (Australian Government 1996, p. 10).

The 1996 competitive neutrality policy applies to government business activities, not just to wholly-owned government businesses (Australian Government 1996). Were 100 per cent ownership a requirement, competitive neutrality principles could be sidestepped through the trivial involvement of a private party. The National Competition Council made its position on this issue clear.

An emerging competitive neutrality complaints issue is the appropriate treatment of complaints about businesses which are partially privatised. Given that the agreed objective of competitive neutrality reform is the 'elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities', the Council believes that complaints mechanisms need to address all complaints which arise as a result of a business's government ownership connections. This would include businesses which are part-owned by governments (NCC 1997, p. 24)

The Australian Government Treasury has also stated that:

The Government's policy of Competitive neutrality applies to the ABGF because of the Commonwealth's shareholding and the commercial nature of [the ABGF's] activities. (Treasury 2020)

Accordingly, even part Australian Government ownership in a significant business activity is sufficient to render it subject to competitive neutrality policy and the complaints mechanism. Previously, the AGCNCO has twice accepted complaints involving businesses in which the Australian Government was only a part owner: National Rail (CCNCO 2000) and ARRB Transport Research Limited (CCNCO 2001).

Consequently, the AGCNCO considers that ABGF is subject to both competitive neutrality requirements and the competitive neutrality complaints mechanism.

⁴ The AGCNCO provided preliminary advice to the Senate inquiry into the provisions of the *Australian Business Growth Fund Bill 2019* in February 2020 (AGCNCO 2020).

Is the complaint within the scope of the AGCNCO?

The *Productivity Commission Act 1998* (Cth) empowers the AGCNCO to investigate complaints that an Australian Government business or business activity is not being conducted in accordance with the competitive neutrality arrangements that apply to it.

In deciding to investigate any complaint the office must have regard to the *Productivity Commission Act 1998* (part 4, division 2) and the 1996 *Competitive Neutrality Policy Statement* (Australian Government 1996) and ensure that the complaint:

- is not better handled by another body
- does not relate to competitive neutrality policies that are being finalised or are currently the subject of review by government
- is not vexatious
- raises issues of substance and with non-trivial resource allocation effects.

The AGCNCO decided to proceed with its investigation as all these conditions are met. The relevant matter (claim 1 above) relates to competitive neutrality and so is appropriately addressed by the AGCNCO. It does not relate to the finalisation or review of any competitive neutrality policies. The complaint is not vexatious, as the ABGF is directly competing in the market in which the complainant is operating. And last, the size of the ABGF is significant, and therefore so too are its potential economic effects.

Scope and conduct of this investigation

This investigation solely concerns the competitive neutrality obligations of the ABGF. As such, this investigation has not considered, and does not reach conclusions on, several matters that have been raised by the complainant as relevant to the Office's functions:

[1] It does not address the policy rationale for either the creation of or Commonwealth investment in the fund. OnMarket BookBuilds Pty Ltd (Letter 24 August 2021, pp. 4–5) questioned whether there was any gap in the market for equity that would justify the ABGF, querying the relevance of claims about gaps in debt markets. Others have also criticised the need for and appropriateness of the government's ownership role in the ABGF and its governance arrangements, as in the paper produced by the Parliamentary Library (Bogaards and Ramesh 2020). However, competitive neutrality policy is not concerned with the desirability of government policy initiatives or government ownership per se, but whether ownership per se confers a competitive advantage. The broader consideration of the merits of government ownership is outside the remit of the AGCNCO.

[2] The apparent variations over time in the turnover ranges for eligibility for access to ABGF equity funding are not material to the investigation. The announcement of the ABGF stipulated that businesses with turnover between \$2 million and \$100 million would be eligible for equity from the Fund (Frydenberg and Cash 2019). This is also the current stipulated turnover range. At other times, the ABGF has stipulated a minimum turnover of \$10 million (Evidence presented by OnMarket BookBuilds, Letter 24 August 2021). The complainant argued that there was a lack of clarity about the genuine turnover floor and a problematic motivation for varying its levels. It said that management of the fund could exclude access to businesses with turnover between \$2 million and \$10 million, which it saw as inconsistent with the goal of the ABGF in supporting small business:

It appears that [in setting a \$10 million lower threshold] the banks/ABGF management decided it would be more profitable at lower risk to invest in large businesses, rather than the SMEs. This breaches the Government's reasons for investing \$100 million of taxpayer funding, and the reasons for lobbying APRA for prudential "special treatment" and APRA's understanding of

it ... It is evident that if the ABGF has already lifted the revenue threshold to \$10 million, then ostensibly dropped it to \$2m to avoid scrutiny, then it appears that there are no constraints on the ABGF lifting the threshold up again to whatever it pleases, after the AGCNCO finishes its investigation. Changing the website to avoid scrutiny does not prevent management from excluding companies with \$2-\$10 million, and their actions reveal this to be their intent (OnMarket BookBuilds, Letter 24 August 2021, p. 3)

As noted in [1], the AGCNCO cannot comment on whether there was a public policy justification for the ABGF, and therefore equally cannot make any judgment on the appropriateness of its eligibility criteria, whether they change or not.

[3] *The impacts of the fund on competition in financial markets is a broader matter.* As discussed at length in the Productivity Commission's inquiry into banking (PC 2018), competition in Australian financial markets is imperfect. ADIs receive preferment through depositor guarantees but face stringent regulatory oversight through prudential requirements that heavily restrict their activities. Non-ADIs face far less regulation, but without the stable base of deposits to lower the cost of capital for their investments. The AGCNCO has not examined the precise effects of these differences for patient equity in the market targeted by the ABGF. However, competitive neutrality policy is not concerned with competition policy generally but with the narrower question of whether the Australian Government has used its legislative or fiscal powers to advantage a government business compared with private businesses operating in the same market.

[4] *The AGCNCO is not an appropriate body to reach conclusions regarding alleged misconduct by the ABGF, APRA or Treasury in their statements about competitive neutrality and other matters relating to the ABGF.* The AGCNCO has only had to satisfy itself that the picture obtained through documents, the testimony of parties and other evidence is of sufficient quality as to make a balanced assessment of the complainant's case.

[5] *The AGCNCO has not re-interpreted the Application of Competitive Neutrality Policy 1996 in light of the inclusion of an effects test in the legislated amendments to the Consumer and Competition Act (CCA).* It is not clear to the AGCNCO that the amendment to the CCA relating to the misuse of market power has a bearing on the application of the Competitive Neutrality Policy Statement (Australian Government 1996). There was never a requirement under that Statement for there to be a purpose to reduce competition. Existing competitive neutrality policy already requires a test of whether, *by dint of their public sector ownership*, government businesses enjoy a net competitive advantage over competitors.

In undertaking the investigation, the AGCNCO has examined the timeline of establishing and regulating the fund to gather relevant evidence. The AGCNCO has also held discussions with the complainant, APRA, the ABGF and the Treasury, and requested access to documents held by APRA, the ABGF and the Treasury. The AGCNCO has also reviewed the ABGF Shareholder Agreement and the preceding ABGF Summary of Key terms.

Both the complainant and APRA provided public statements on matters relating to this investigation, which has been made available on the AGCNCO website (<https://www.pc.gov.au/competitive-neutrality>).

The criterion for the AGCNCO's judgment is the 'balance of probabilities', taking into account the incomplete documentary evidence for making the assessment and given opposing views of the participants.

The AGCNCO provided a draft report in July 2021 to the complainant, APRA the ABGF, and the Australian Government Treasury for their feedback. We thank participants for their subsequent input. It should be noted that the complainant has been attempting through freedom of information provisions to obtain the Shareholder Agreement and the Statement of Key Terms but had not been successful at the time of completion of this investigation. Given the potential importance of these documents, the AGCNCO was able to examine these documents on a confidential basis as part of our assessment.

2. Competitive neutrality issues associated with the Australian Business Growth Fund

A breach or not?

The key question is whether APRA's treatment of ADI investments in the ABGF was because of Government shareholding in the ABGF. To find a breach would require that APRA would not have provided the *same* risk treatment for ADI investments in the ABGF if the Australian Government were not a shareholder. Regulatory neutrality would hold if a comparable fund owned by ADIs, with a similar profile and structure, but without Government shareholding, would be able to access the same regulatory treatment.⁵

The AGCNCO's assessment has therefore considered whether APRA determined the capital treatment prior to knowledge of any government shareholding, the consistency of the treatment with like funds overseas that do not have government as a shareholder, and whether APRA's treatment is exclusive to investments in the ABGF as a part government-owned entity (and not to any potential competitors).

APRA internally developed the capital treatment of investments in the ABGF prior to becoming aware of Government ownership

Some public statements made by APRA imply that the risk treatment of ADI investments in the ABGF is a direct consequence of the Australian Government's partial ownership. APRA's decision letter to banks, outlining the capital treatment of investments in the ABGF, noted that 'the inclusion of the Australian Government as a founding shareholder in the ABGF *supports* APRA providing a special treatment' (APRA 2019a) (emphasis added). On face value, this lends credence to the complainant's concerns, but is not adequate evidence to conclude a breach of regulatory neutrality.

When this claim was put to APRA, they stated in a letter to the AGCNCO that (a) they did not take government ownership into account in developing the treatment, (b) that they had developed the capital adequacy test for investments in the fund internally and *prior* to learning that the Australian Government would have an ownership stake, and (c) that the principles applied in this decision would also be applied to any decisions made for investments in other similar funds without a government stake, subject to their structure and design (APRA 2021b, pp. 2–3).

APRA stated in a subsequent letter to the AGCNCO that on 27 November 2018 it determined the in-principle capital treatment for the ABGF based on the provisional structure of the fund, with its policy governance

⁵ As it currently stands, APRA's capital treatment of ADI investments in the ABGF is notionally exclusive only to investments in the ABGF. This point is considered below.

committee provisionally endorsing the proposed capital treatment (APRA 2021a). APRA stated that it 'was not aware at this time of the Government's decision to invest in the ABGF'.

APRA disclosed an excerpt of the minutes of that committee meeting to the AGCNCO, which made no reference to government support or ownership. APRA told the AGCNCO that it was only made aware of that decision following the Australian Government's media release on 23 April 2019.⁶ APRA also noted that there was no change to the initial determination made in November 2018 and its final determination in October 2019 (APRA 2021a). Taken at face value, this is consistent with the viewpoint that the decision by the Australian Government to invest in the fund did not affect the capital treatment.

Table 1 – Sequence of events

Date	Event and source
2015	APRA claimed that an international bank approached APRA seeking to replicate similar structures in place internationally. An option preliminarily considered by APRA was a capital treatment similar to that eventually determined for ADI investments in the ABGF, and did not factor in any government shareholding (APRA 2021b, p. 2).
27 November 2018	Provisional capital treatment developed by APRA and agreed to by an internal policy committee (APRA 2021a).
6 December 2018	Roundtable held between major banks, the Australian Government, APRA and other parties. APRA presented its views on appropriate capital treatment. The ABGF was characterised as a privately-owned fund (Australian Government Treasury 2018).
23 April 2019	Australian Government announced an election commitment to invest in the ABGF (Morrison, Frydenberg and Cash 2019). This is the first time APRA was made aware that the Australian Government was to be a shareholder (APRA, pers. comm. 6 August 2021).
28 October 2019	APRA finalised the capital treatment of the ABGF consistent with the treatment developed in November 2018 prior to its knowledge of any government ownership (APRA 2021a).
27 November 2019	Australian Government announced the formation of the ABGF, including its ownership role (Frydenberg and Cash 2019).
9 December 2019	APRA publishes a letter confirming the capital treatment of ADI investments in the ABGF (APRA 2019a).
16 October 2020	ABGF formally established (Frydenberg 2020).

This sequence of events (table 1) is supported by other evidence from the Australian Government Treasury relating to a roundtable on 6 December 2018 hosted by the Treasurer, Josh Frydenberg, which included representatives from the Australian Government, APRA, the Reserve Bank of Australia, the Australian Competition and Consumer Commission, the Australian Small Business and Family Enterprise Ombudsman, the Australian Banking Association, the Council of Small Business Organisations Australia and various

⁶ APRA, pers. comm., 6 August 2021.

financial institutions (predominantly ADIs). Talking points⁷ provided to the Treasurer for the ABGF included the statement:

To help SMEs accessing equity finance, we are encouraging the establishment of the private sector-owned Australian Business Growth Fund. (Australian Government Treasury 2018, p. 2).

Various reports by journalists around the time of this roundtable are also consistent with the ABGF initially being a fund solely owned by financial institutions and subject to the capital treatment that also finally applied to the partial government-owned ABGF (box 2).

Box 2 – Information published by media in 2018

A newspaper report published prior to the 6 December 2018 Roundtable on the ABGF specified the fund as purely private in nature:

The government’s planned Australian Business Growth Fund, which would be financed by private lenders, is top of the items due to be discussed on Thursday next week, according to a draft schedule of the meeting obtained by the *Australian Financial Review*. ... The proposed bank-financed equity fund, which would take minority stakes in promising SMEs, is unusual because banks typically lend debt to clients, not invest equity in small business. (Kehoe and Eyers 2018)

A subsequent article by a journalist briefed about the roundtable and interviewing various participants at the time reiterated the private nature of the fund and that APRA was willing to provide a concessional treatment of capital — this concession is consistent with that later applied to the ABGF when it became a partially government-owned business:

A government-proposed fund for banks to inject equity into growing small businesses has received a boost, with the prudential regulator signalling it is willing to consider regulatory concessions to make the vehicle commercially viable. ... “The big change was APRA seemed very open to changing the risk weighting for money going into the fund”, Council of Small Business of Australia chief executive Peter Strong said after attending the meeting. ... Bankers said for the fund to be commercially viable, APRA would need to soften the capital deduction for banks’ equity investments, from a risk weighting of 400 per cent to up to 1250 per cent to around the international standard of 250 per cent. ... NAB small business executive Leigh O’Neill said the proposed fund was an opportunity to jointly support SMEs. “There is a great chance to collaborate with other banks and financial institutions like superannuation funds who do make investments and see long-term growth opportunities in SMEs,” she said. Other local banks such as Commonwealth Bank of Australia, Westpac and Macquarie, and superannuation funds, such as AustralianSuper, which was represented at the meeting, still need to be convinced to join the unconventional fund. “We welcome this initiative and are ready to take part provided the appropriate governance and investment criteria are put in place”, CBA executive Adam Bennett said after attending the meeting. (Kehoe 2018)

⁷ In response to a request for information, the Treasury provided the AGCNCO with a confidential copy of the talking points. Since then, the relevant document has been released by Treasury after another party’s freedom of information request and is in attachment A of that document (Australian Government Treasury 2018).

APRA has previously considered comparable treatment for similar funds without Government ownership

APRA claims that an approach to develop a fund similar to the ABGF, but without any government stake, had occurred well before the proposal for the ABGF, and that APRA had considered a capital treatment similar to that ultimately provided to investments in the ABGF.

... APRA has been approached in the past by stakeholders seeking to establish funds with a similar design and purpose to the ABGF, without government involvement. The most notable example of this was in 2015 when an international bank approached APRA seeking to replicate similar structures in place internationally. One option preliminarily considered by APRA at that time was a similar capital treatment to that eventually determined for ADI investments in the ABGF. Ultimately, those proposals did not proceed beyond the discussion stage. To the best of APRA's knowledge, that proposal did not include a Government ownership stake. (APRA 2021b, p. 2)

It further noted that, in the event a competing fund was proposed:

APRA would apply the same principles in determining the appropriate capital treatment in any similar funds, but the exact level of the capital treatment would depend on the specific structure and design. (APRA 2021b, p. 2)

APRA did not provide the AGCNCO with any documentation about the historical application for an equity fund and the associated preliminary consideration of its capital adequacy. However, the AGCNCO notes that the information provided by APRA is consistent with its previous testimony to the Senate Economics Legislation Committee. Further, APRA noted that the Australian Government's ownership stake in the fund 'certainly wasn't a requirement' for the capital treatment provided (Senate Economics Legislation Committee 2020b, p. 13).

APRA's special treatment for investments in the ABGF is consistent with the rationale of the fund

APRA stated that it supported the establishment of the fund because of its benefits in increasing the availability of finance for SMEs in supporting the overall financial system, not because of the Australian Government's shareholding.

This revised treatment recognises the wider financial system benefits from increasing access to financing for SMEs. (APRA 2019a)

The fund was championed by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO 2018), which cited banks' concerns that a factor behind the hitherto small role played by ADIs in patient capital were APRA's restrictive regulations (p. 19). The Reserve Bank of Australia also noted the more restrictive nature of APRA's regulatory capital framework for equity investment by banks compared with that of the UK Prudential Regulation Authority (Connolly and Bank 2018, p. 11). In the ABGF Roundtable held on 6 December 2018, banks are reported to have said that there was need for a concessional capital treatment for the fund to be commercially viable (box 1). Accordingly, the treatment of capital by the prudential regulator is recognised as an important determinant of the commercial feasibility of equity finance provision by ADIs.

APRA considered providing specific capital treatment to investments in the ABGF after being requested to do so by the Australian Government but, as noted above, the Government was not a shareholder when APRA made its internal determination on 27 November 2018. Further, the AGCNCO has not found any evidence that an ownership stake was under consideration when APRA made an initial determination.

The merits of any Government *support* of this nature — including efforts to reduce regulatory burden, where this does not include ownership — is not a competitive neutrality issue and is thus out of scope of this investigation.

In summary, APRA's claim that it considered the appropriate capital treatment of the ABGF from the perspective of broader financial stability but without an expectation of any Australian Government ownership of the fund, is consistent with the relevant evidence available to the AGCNCO about the development of the ABGF.

The international precedent indicates that relaxed capital treatment of this nature is not dependent on government ownership

APRA indicated that its choice of the risk weight in the capital requirement test for investments in the ABGF is consistent with the level of diversification of risk, international regulatory frameworks (Basel III), the structure and objectives of the fund, and precedents set by the UK and Canadian business growth funds (APRA 2021b, p. 2). APRA also stated to the Senate Economics Legislation committee that:

APRA's capital requirements for investments in the fund ... [are] consistent with a discretionary option for equity investments in financial institutions under the internationally agreed Basel III capital framework. It is also broadly consistent with the approach taken in other jurisdictions that have comparable business growth funds, such as the UK and Canada. (Senate Economics Legislation Committee 2021, p. 3)

The AGCNCO has verified that APRA's approach to capital treatment of ADI investments in the ABGF is broadly consistent with international precedent, including similar funds that do not involve government ownership.

The Basel Framework allows for a 250 per cent risk weighting for substantial non-controlling equity investments⁸ if the investment is less than 10 per cent of the bank's regulatory capital (appendix A). APRA's requirement that the ABGF be limited to 2 per cent of an ADI's CET1 capital further limits their exposure to risk.

In the UK and Canada, the relevant growth funds do not have a government shareholder. In Canada, the Government amended the *Bank Act 1991* to clarify certain aspects of how investments in the Canadian Business Growth Fund are to be treated (for example, in terms of limits on the investments by any single entity, the extent of controlling power, and on the involvement of foreign entities) — all of which reduced the risk exposure for any given investor. But the key point is that these regulations did not differentiate between government and private ownership. Therefore, in both the UK and Canadian funds, the regulatory framework allows other funds similar to the ABGF to receive comparable treatment if they meet certain conditions.

APRA has also stated that its capital adequacy test was more conservative than the comparable funds in the United Kingdom and Canada:

... the other two funds we looked at were those in the United Kingdom and in Canada. Generally speaking, they had an equivalent risk weight approach, but they actually had a lower risk weight for these types of equivalent exposures than Canadian banks. We were a little bit more conservative and our capital framework for banks in Australia is based on an international framework, and we looked to that framework to better align what we're considering in Australia, and we used that framework and looked at what that framework proposed, and that's where we landed on the 250 per cent risk weight. So, it's a little bit more conservative than other jurisdictions, but it is aligned to the international framework. (Senate Economics Legislation Committee 2020b, p. 12)

The AGCNCO has independently confirmed with the Prudential Regulation Authority (the UK equivalent to APRA) that the treatment available to investments in the UK Business Growth Fund can be as low as a

⁸ The Basel framework stipulates that this would apply where a bank's non-controlling investment exceeds 10 per cent of the ABGF's overall investment pool, which is met by the big four banks.

100 per cent risk weighting, depending on the specific approach to risk weighting used by the financial institution in question.⁹

In summary, the provision of the relevant capital treatment to the ABGF by APRA is consistent with international requirements under the Basel framework and international precedent, regardless of partial government ownership.

The fund's shareholder agreement does not contain any provision that represents a competitive neutrality breach

The shareholder agreement could be relevant to the competitive neutrality complaint if it indicated that Australian Government stake was an essential prerequisite to the capital adequacy treatment of the fund. For example, that might occur if the Australian Government was to bear a greater degree of risk than its ADI partners. The AGCNCO obtained confidential time-limited access to the ABGF Shareholder Agreement from the ABGF. The AGCNCO is satisfied that no part of the agreement relating to the Government's role as a shareholder provides any commercial advantage to ADIs or had any influence on APRA's capital treatment of the fund.

The ABGF Summary of Key Terms also does not suggest any breach

The AGCNCO sought and obtained a confidential copy of the ABGF Summary of Key terms. This document sets out the intentions of the parties at the time (October 2019) concerning key commercial and legal principles for the establishment of the ABGF. It is indicative and non-binding. It formed the basis of the ABGF Shareholders' Agreement above. As for that agreement, the document does not suggest that government ownership had any bearing on APRA's capital treatment.

Conclusion

The core claims made by APRA — relating to the timing of its internal decision on the capital treatment of the ABGF, that the decision was made absent any knowledge of government ownership and regardless of any potential ownership, and that it had previously considered comparable treatment for similar privately-owned funds — are consistent with the evidence that APRA also provided publicly to the Senate Economics Legislation Committee. The testimony provided by APRA to the Committee and to the AGCNCO also accords with evidence provided by the Australian Government Treasury and the reported comments to media by key proponents of the ABGF.

Further, the AGCNCO has been able to verify that the capital treatment provided to investments in the ABGF is broadly consistent with both the discussions leading up to the establishment of the ABGF — prior to the announcement of government ownership — and the regulation of overseas funds (which are not government-owned). Moreover, nothing in the fund's shareholder agreement or the ABGF Summary of Key Terms suggests that the capital treatment of the ABGF was contingent on the Australian Government's participation in the fund.

Nevertheless, the AGCNCO notes that a number of claims made by APRA have not been supported by full documentary evidence, such as background papers, complete minutes of meetings, or records of decision. This has made the task of the AGCNCO more difficult. However, APRA's failure to provide the AGCNCO with the documents underpinning its decision-making is not evidence that the relevant decisions were not made. Further, no concrete evidence has been provided that contradicts the series of events outlined by APRA.

⁹ Correspondence 2-3 November 2021.

On the balance of probabilities, the AGCNCO finds no breach of competitive neutrality policy resulting from the Australian Government's ownership stake in the ABGF.



Finding 1

The risk treatment afforded by the Australian Prudential Regulation Authority to investments made by authorised deposit-taking institutions in the Australian Business Growth Fund, in which the Australian Government is a minority shareholder, does not constitute a breach of regulatory neutrality under the Australian Government's competitive neutrality policy.

Apparent exclusivity of the treatment of the ABGF

Even though the regulatory treatment of the ABGF is not a direct result of Australian government shareholding, the treatment is currently only available to investments in the ABGF. It is reported that at the ABGF Roundtable of 6 December 2018 (before government had expressed any interest in being a shareholder), APRA indicated that its prospective capital treatment was restricted to one entity:

The APRA criteria included: there be only one such fund; a diversity of SMEs receive equity to avoid concentration risks; fund management is independent of its bank owners; it be open for new funding members to join; the funding source to be drawn from about five or six institutions; and contributions from individual banks be capped. (Kehoe 2018, p. 2)

This could create an appearance that the regulatory treatment is exclusive to investments in a fund involving some level of government ownership. However, subsequently, in information provided to the AGCNCO, APRA indicated that they would assess whether ADI investments in any other proposed fund would be eligible for a similar treatment to those in the ABGF, but the treatment available to investments in the ABGF would not automatically be available. As APRA notes: 'the exact level of the capital treatment would depend on the specific structure and design' (APRA 2021b, p. 2).

A drawback of this approach is that its lack of specificity may still create an impression of a lack of regulatory neutrality, while at the same time potentially acting as a barrier to the development of any competing equity fund. Notably, the capital treatment of investments in the Canadian and UK business growth funds do not appear to be exclusive to the particular fund and would be available for other comparable funds. Consequently, there are grounds for APRA to publicly provide greater specificity about the circumstances in which investments by ADIs in any competing fund would be eligible for the same capital treatment as investments in the ABGF.



Recommendation 1

To remove any appearance of exclusivity of the capital adequacy test for investments by authorised deposit taking institutions in the Australian Business Growth Fund, the Australian Prudential Regulation Authority could provide greater specificity about the circumstances in which investments by ADIs in any competing fund would be eligible for the same capital treatment.

Did APRA comply with its legislative requirement to balance competitive neutrality?

The Australian Government's competitive neutrality policy unquestionably applies to the ABGF, with the accountable party being the Australian Government. A secondary question is whether there is an additional requirement for APRA to consider competitive neutrality. The complaint claimed that APRA did not comply with their legislative requirement to consider competitive neutrality in making their decision. That legislative requirement is spelt out in Section 8(2) of the *Australian Prudential Regulation Authority Act 1998* (Cth), which states that:

In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and **competitive neutrality** and, in balancing these objectives, is to promote financial system stability in Australia. (emphasis added)

In its draft report, the AGCNCO reached the conclusion that this provision is limited to the entities that APRA regulates. APRA's regulatory functions mainly relate to ADIs,¹⁰ which are now fully privately owned. Our view was that, as APRA does not regulate the fund itself, the competitive neutrality aspect of section 8(2) does not require a detailed assessment. While we contend that this is probably a reasonable conclusion, the complainant disagreed, noting that:

It is a complex legal question as to whether it can be *implied* that APRA's obligation to consider competitive neutrality is constrained to *only* to ADIs. We note that the APRA Act does not narrow the scope of APRA's obligations explicitly, and that there are multiple instances in the Act referring to APRA's obligations in relation to "financial stability in Australia". Narrowing APRA's obligations to only ADIs, would render many references in the APRA Act meaningless. ... We respectfully submit that AGCNCO's [draft] findings pertaining to the APRA Act are ultra vires ['beyond the powers'], and therefore should be removed from the report. (OnMarket BookBuilds, Letter 24 August, p. 17)

We accept the complainant's view that to investigate this complaint, the AGCNCO does not need to make any finding about whether APRA did or did not meet its competitive neutrality obligations under its Act.

Australian Government joint ventures present a unique challenge for competitive neutrality

Given the involvement of the Australian Government as well as private banks, the ABGF case presents a unique challenge for competitive neutrality. Where a fully government-owned business has failed to meet the requirements of competitive neutrality, the remedy is elimination of the competitive advantage directly or a competitive neutrality payment by the business to the Australian Government, calibrated to remove the competitive advantage. This is readily achieved.

However, where the Australian Government is in a joint venture with private entities and subsequently a competitive neutrality breach becomes apparent, restoring competitive neutrality would require that the venture bear additional costs. By design, the remedy for a breach of competitive neutrality must change the

¹⁰ APRA also regulates general, life and health insurers, reinsurance companies and most superannuation funds). From 2018, APRA also has some regulatory powers over non-ADIs through the *Treasury Laws Amendment (Banking Measures No. 1) Act 2018* (Cth), but these relate to lending only and their intent is to ensure the financial stability of the Australian financial system and do not include consideration of competitive neutrality.

relative price of the outputs of the joint venture compared with competitors, with commercial consequences that would extend to the private joint partners. Contract provisions between parties in the venture may further add to the complexity of addressing any such breach.

This provides an additional imperative for scrutiny by the Australian Government of the compliance of government-private joint ventures with competitive neutrality policy prior to their establishment. Further, transparency in the establishment and regulation of any similar venture will help nullify concerns over the competitive neutrality implications of those decisions.

Clearer guidance on this could be developed as part of Treasury's Competitive Neutrality Review, which has yet to finalise its deliberations and release its report.

Further, as with all entities subject to competitive neutrality policy, the ABGF must report annually on how it has discharged its obligations under that policy, in order to provide transparency over the continued implementation of competitive neutrality policy. This obligation should be clearly stated.



Finding 2

Assessing and remedying a breach of competitive neutrality may be more difficult for a partly-owned government business than one fully owned by government. This increases the imperative for a careful and transparent assessment of competitive neutrality prior to government becoming a part owner of a business.

A. International prudential treatment of equity investment

Basel Framework

The default treatment of substantial minority equity investments under the international Basel Framework is that:

Significant minority investments in banking, securities and other financial entities, where control does not exist, will be excluded from the banking group's capital by deduction of the equity and other regulatory investments. (Basel Framework, SCO30.4).

However, sections 30.29-30.34 of *CAP30 – Definition of capital* allow for a regulatory adjustment where a bank's non-controlling investment exceeds 10 per cent of that entity's (in the relevant case here, the ABGF) available ordinary shares (Basel Committee on Banking Supervision 2021). While these would usually be deducted from regulatory capital, they can be risk weighted at 250 per cent (30.34) if the significant investment (30.32(1)) does not exceed 10 per cent of the bank's CET1 regulatory capital (30.33).

UK Business Growth Fund

The UK Business Growth Fund was established in 2011 with a £2.5 billion commitment from five major banks (DBIS (UK) nd). The UK Government supported development of the fund but is not a shareholder.

Bank investments in the fund are treated as risk-weighted asset 'subject to the scale and diversity of the portfolio' (Bank of England 2015, p. 37). Amendments were made to prudential rules in 2011 to confirm this treatment (FSA (UK) 2011, p. 9). The amendment is drafted as a general rule for particular investment vehicles, rather than being an adjustment available only to the UK Business Growth Fund.

Canadian Business Growth Fund

The Canadian Business Growth Fund was established in 2018, with funding commitments of C\$1 billion over ten years (Department of Finance Canada 2018). No Government is a shareholder: in proposing the fund, the Advisory Council on Economic Growth viewed the role for government as '(a) highlighting the potential capital need; (b) convening and coordinating the different sources of capital, and (c) clarifying the capital treatment for investments in this fund' (Advisory Council on Economic Growth (Canada) 2017, p. 24).

The Fund was not provided any specific treatment by the prudential regulator. The report proposing the fund noted that a lower risk weighting was already available for 'non-substantial' equity investments (defined as representing less than 10 per cent ownership) (Advisory Council on Economic Growth (Canada) 2017, p. 36). Where those investments are less than 10 per cent of regulatory capital, Canadian banks can risk-weight those holdings based on credit or market risk rather than capital deduction (OSFI (Canada) 2018, paragraph 75).

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