AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY

LEADING AUSTRALIAN BUSINESS

ACCI SUBMISSION TO THE SENATE ECONOMIC REFERENCES COMMITTEE

Inquiry into Access of Small Business to Finance

March 2010

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1. ACCI LEADING AUSTRALIAN BUSINESS

ACCI has been the peak council of Australian business associations for 109 years and traces its heritage back to Australia's first chamber of commerce in 1826.

Our motto is "Leading Australian Business."

We are also the ongoing amalgamation of the nation's leading federal business organisations – the Australian Chamber of Commerce, the Associated Chamber of Manufactures of Australia, the Australian Council of Employers Federations and the Confederation of Australian Industry.

Membership of ACCI is made up of the State and Territory Chambers of Commerce and Industry together with the major national industry associations.

ACCI also operates internationally. It represents Australian business in the forums of both the international chamber movement and the international employer movement and is recognised by international bodies as the most representative voice of Australian business organisations.

Through our membership, ACCI represents over 350,000 businesses nation-wide, including over 280,000 enterprises employing less than 20 people, over 55,000 enterprises employing between 20-100 people and the top 100 companies.

Our employer network employs over 4 million people which makes ACCI the largest and most representative business organisation in Australia.

1.1 Our Activities

ACCI takes a leading role in representing the views of Australian business to government, our federal parliamentarians, government agencies and regulators.

Our objective is to ensure that the voice of Australian businesses is heard, whether they are one of the top 100 Australian companies or a small sole trader.

Our specific activities include:

- representation and advocacy to Governments, parliaments, tribunals and policy makers both domestically and internationally;
- business representation on a range of statutory and business boards and committees;
- representing business in national forums including Fair Work Australia, Safe Work Australia and many other bodies associated with economics, taxation, sustainability, small business, superannuation, employment, education and training, migration, trade, workplace relations and occupational health and safety;
- representing business in international and global forums including the International Labour Organisation, International Organisation of Employers, International Chamber of Commerce, Business and Industry Advisory Committee to the Organisation for Economic Co-operation and Development, Confederation of Asia-Pacific Chambers of Commerce and Industry and Confederation of Asia-Pacific Employers;
- research and policy development on issues concerning Australian business;
- the publication of leading business surveys and other information products; and
- providing forums for collective discussion amongst businesses on matters of law and policy.

1.2 Publications

A range of publications are available from ACCI, with details of our activities and policies including:

- The *ACCI Review*; an analysis of major policy issues affecting the Australian economy and business.
- Submissions and policy papers commenting on business' views of contemporary issues affecting the business community.
- The Policies of the Australian Chamber of Commerce and Industry.
- The *Westpac-ACCI Survey of Industrial Trends* - the longest, continuous running private sector survey in Australia. A leading barometer of economic activity and the most important survey of the Australian manufacturing industry.
- The *ACCI Survey of Investor Confidence* – which gives an analysis of the direction of investment by business in Australia.
- The *Commonwealth Bank - ACCI Business Expectations Survey* - which aggregates individual surveys by ACCI member organisations and covers firms of all sizes in all States and Territories.
- The *ACCI Small Business Survey* – a regular survey of small business conditions and expectations.
- Workplace relations reports and discussion papers, including the ACCI *Modern Workplace: Modern Future 2002-2010* Policy Blueprint and the *Functioning Federalism and the Case for a National Workplace Relations System* and *The Economic Case for Workplace Relations Reform* Position Papers.
- Occupational health and safety guides and updates, including the National OHS Strategy 2002-2012 and the *Modern Workplace: Safer Workplace 2005-2015* Policy Blueprint.
- Trade reports and discussion papers including the *Riding the Chinese Dragon* and *Riding the Indian Elephant* Position Papers.
- Education and training reports and discussion papers, including the *Skills for a Nation 2007-2017* Policy Blueprint.
- The ACCI Taxation Reform Blueprint: *A Strategy for the Australian Taxation System 2004–2014*.
- The ACCI Manufacturing Sector Position Paper *The Future of Australia's Manufacturing Sector: A Blueprint for Success*.
- The *ACCI President's Report* – a periodical on ACCI corporate activities.
- The *ACCI Annual Report and Business Review*, providing a summary of major activities and achievements for the previous year.

Most of this information, as well as ACCI media releases, submissions and reports, is available on our website – www.acci.asn.au

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2. Introduction

1. Since the onset of global financial crisis in June 2007, Australian banks have become more risk averse and have further tightened their lending criteria and increased risk margins, especially for business borrowers. Moreover, Australian banks have also faced significant increases in their cost of funding resulting in negative flow-on effects on lending rates applying to Australian borrowers, in particular small businesses.

2. Small businesses have continued to face difficulties in accessing finance from Australian banks and this can occur even when a solid lending proposal exists. Unlike larger businesses, small businesses do not have the capacity to raise external finance through equity or corporate bond issuance and therefore rely heavily on intermediated finance from financial institutions for their working capital, new capital expenditure e.g. on machinery, plant and equipment as well as opportunities for overall expansion. Declining profits since the downturn, as evident from ACCI surveys, have continued to put downward pressure on small business retained earnings and further limited the sources of available finance.

3. Moreover, small businesses also face higher interest rate charges for small business loans relative to other borrowers. Data from the Reserve Bank of Australia (RBA) indicates that after the three successive interest rate hikes over the December quarter of 2009, small businesses were paying a margin of 3.97 percentage points above the cash rate on average for bank finance, compared to a margin of 2.29 percentage points for large businesses and 2.32 percentage points for mortgage customers[1], despite most of these business loans being residentially secured.

4. As the economy recovers and an increasing number of small businesses wish to expand and invest, a real risk is that repricing of risk at this end of the market will have a negative impact on growth and employment opportunities. Small businesses employ around 50 per cent of Australia's private sector labour force and produce nearly 40 per cent of private sector industry value-added[2], they remain a vital engine of private sector growth.

[1] Reserve Bank of Australia (RBA) 2010, *Statement on Monetary Policy*, February 2010, page 46.
[2] http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/SmallBusinessFactSheet.aspx.

3. COST OF FINANCE

3.1 Interest Rate Charges

5. The global financial crisis has pushed up Australian banks funding costs relative to the cash rate as banks' funding mix shifted towards domestic deposits and long term wholesale debt, which are typically more stable. Given these sources of funding are relatively more expensive, it has also contributed to a rise in the banks' overall funding costs.

6. It was estimated that the average cost of the major banks' funding is about 130-140 basis points higher relative to cash rate than it was during mid 2007. However since mid-2009, the major banks' overall funding costs are estimated to have risen only a little more than the cash rate[3].

7. At the same time, banks' lending rates have increased relative to the cash rate, reflecting the increase in funding costs. While the banks have raised their lending rates relative to the cash rate for all of their loan products, the magnitude of the increase has varied considerable across the different loan types depending on:

   a. the banks' consideration of the riskiness of the borrower;

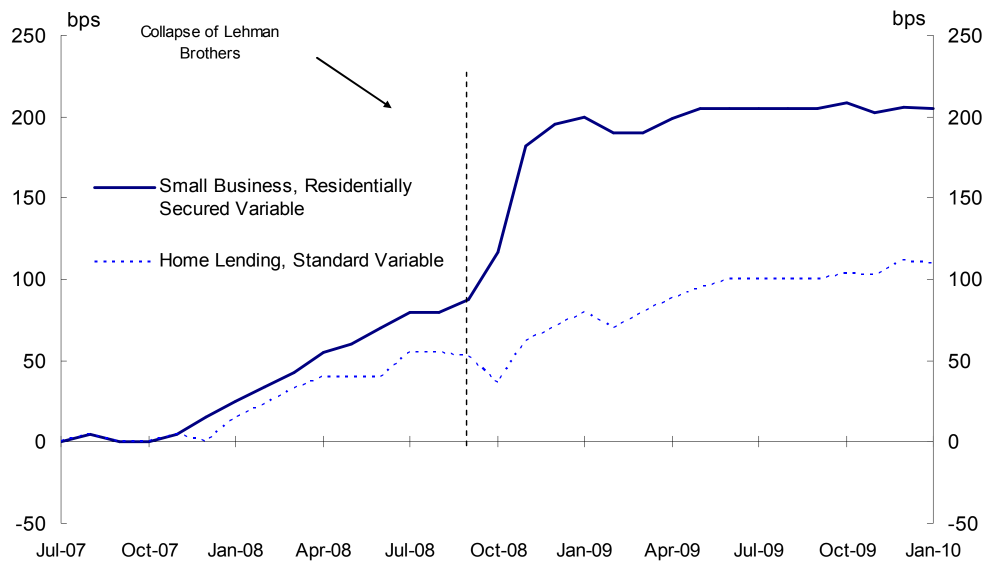
   b. the speed at which loans can be repriced; and

   c. the sensitivity of the borrower to changes in lending rates[4].

8. It is evident from Figure 1 below that the increases in lending rates relative to the cash rate are much larger for small business loans than housing loans since June 2007. Since mid 2007, the standard variable rate on home lending has increased by around 110 basis points (bps) relative to cash rate, while the variable rate of small business residentially secured lending has increased by around 205 bps.

[3] Brown, et al. 2010, "Recent developments in banks' funding costs and lending rates", *RBA Bulletin,* March 2010, page 41.
[4] *Ibid.*, page 42.

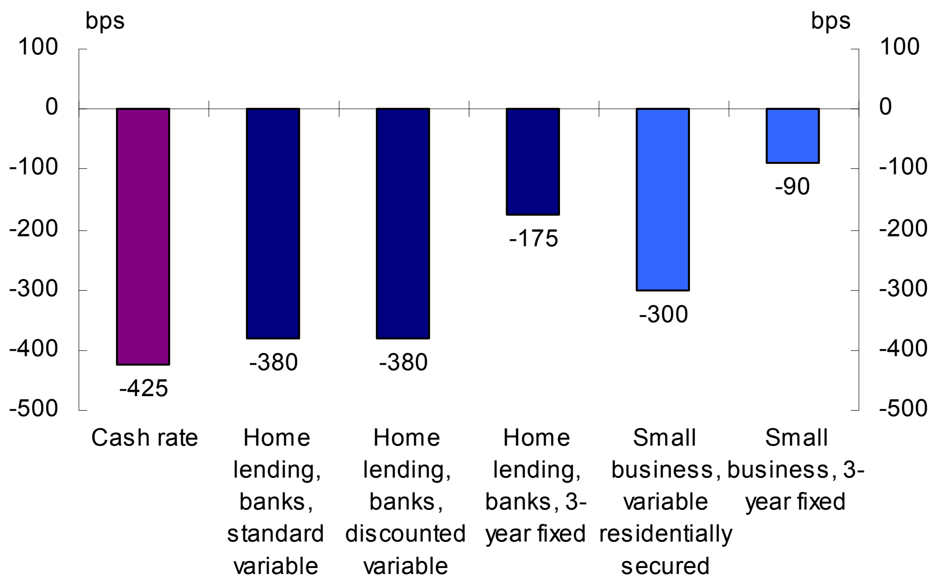
Figure 1: Cumulative change in lending spreads to the cash rate



Source: *RBA Statistical Table F05.*

9. Banks did not pass on the full reductions in the cash rate between August 2008 and September 2009 to borrowers. While the RBA reduced the cash rate by -425 bps, variable home lending rates only fell by -380 bps and variable small business lending rates fell by a mere -300 bps (Figure 2).

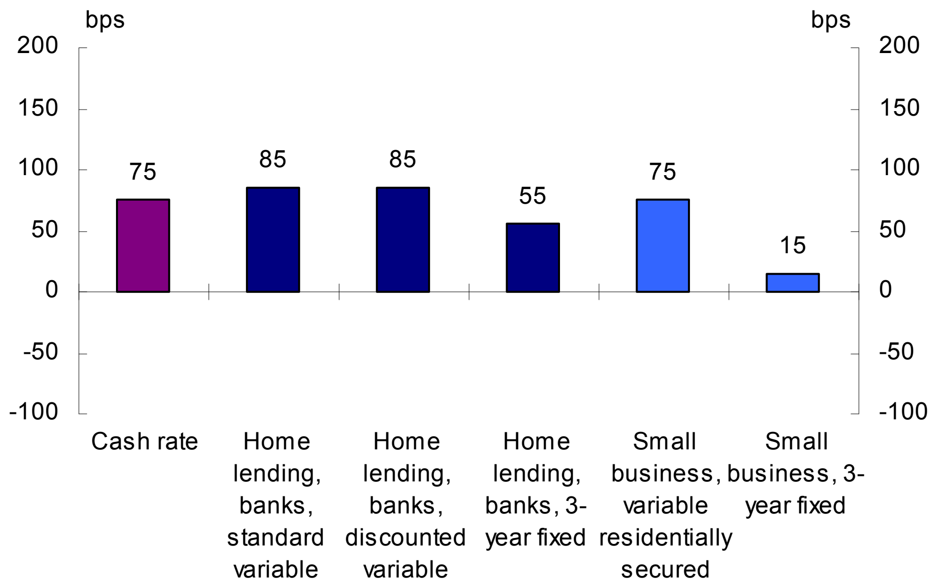
Figure 2: Changes in lending rates – August 2008 to September 2009



Source: *RBA Statistical Table F05.*

10. However major lenders have fully passed on, if not by more, the 75 bps increase in the cash rate between September 2009 and February 2010 to borrowers (Figure 3).

Figure 3: Changes in lending rates since September 2009



Source: *RBA Statistical Table F05.*

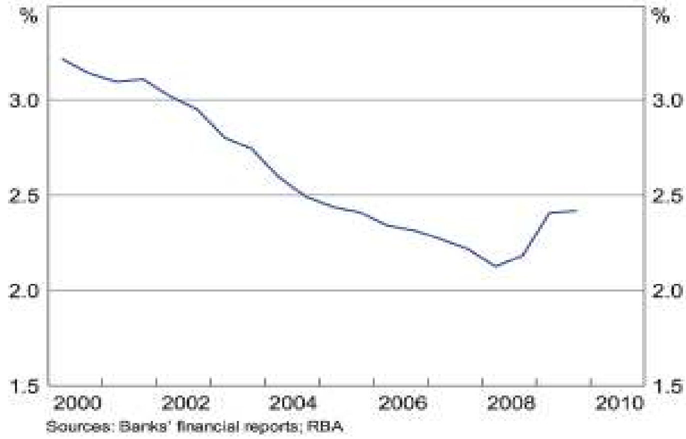
11. Between 2000 and 2007, the net interest margin (NIM) – the margin between the average interest rate on bank loans and the average cost of funding – on major banks' Australian operations fell by around 100 basis points (Figure 4) driven mainly by increasing competition. Despite the fall in NIM, sizeable reductions in bank's operating expenses allowed the banks to continue operating profitably[5].

12. However since 2008, the NIM has widened again. According to RBA estimates, the average NIM for major banks on their Australian operations was around 2.4 per cent in the second half of 2009, about 20-25 bps above pre-crisis level[6]. It is ironic that the impact of the global financial crisis has been to increase banks' NIMs.

13. The recent widening of NIM was largely due to wider margins on banks' business lending. While the margins on variable housing loans remain relatively unchanged compared with their pre-crisis level, margins on business loans have increased substantially than they were before the crisis[7].

[5] Battellino, R. 2009, "Some comments on bank funding", Remarks to the 22nd Australasian Finance and Banking Conference, 16 December 2009.
[6] Brown et al., *Op. cit.,* page 43.
[7] Battellino, *Op. cit.*

Figure 4: Major bank's net interest margin



14. The major banks' higher net interest margins have supported their profitability despite increasing bad and doubtful debt provisions. While, major banks' bad and doubtful debt provisions are now around $10 billion more than they were prior to the crisis when they fluctuated around $2 billion. Higher NIMs have enabled the major banks to claw back their income and increase their underlying profits from around $27.7 billion in the financial year (FY) ending September 2007 to around $35.1 billion in the FY ending September 2009, making 2009 a record year for the major banks' underlying profitability (Table 3 below)[8].

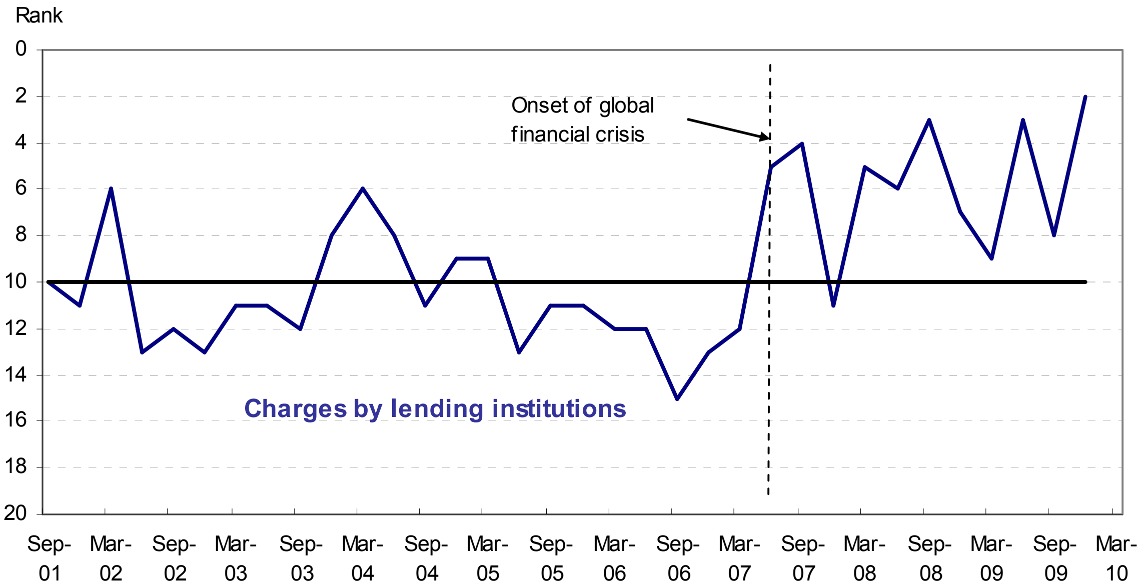
3.2 Other Bank Fees or Charges

15. Aside from higher interest rate charges, businesses are also facing higher bank charges or fees since the onset of global finance crisis.

16. Since June 2007, the *ACCI Small Business Survey* found that *Charges by Lending Institutions* consistently ranked within the top ten constraints on small business investment in plant and equipment (Figure 5).

[8] Richardson, D. 2010, "A licence to print money: bank profits in Australia", *The Australian Institute Policy Brief No. 10*, March 2010, page 4.

Figure 5: Selected constraint on small business investment



Source: *ACCI Small Business Survey,* February 2010.

17. Case studies collected by ACCI members have also highlighted this concern:

   a. **Case study A:** One of the larger retail banks has increased the overdraft fees by 70 per cent without any prior discussion with small business owners. The fee will increase from $1,000 to $1,700 for an overdraft limit of $100,000 commencing from June 2010.

   b. **Case study B**: The annual fee for a business overdraft facility will increase from $1,250 per annum to $2,550 per annum, an increase of over 100 per cent.

18. In both of these cases, the reason given by the bank was that recent changes to regulatory requirements on the capital that banks need to put aside for lines of credit have increased the cost of providing banking services. These new regulatory changes require the banks to put aside additional capital on lines of credit even if they are not drawn by customers.

4. Difficulties in Accessing Finance

19. While the cost of finance is an issue for small business borrowers, an immediate and greater concern for small businesses is the availability of finance from major lenders. Since the crisis, banks have repriced risks for existing loan facilities and tightened the terms and conditions under which they are willing to extend credit to borrowers, in particular business borrowers.

20. The banks' ratio of non-performing assets (NPA) to total on-balance sheet assets increased modestly during the period of financial turmoil but has since remained

broadly flat at around 1.5 per cent since mid 2009. Most of the recent increase in the NPA ratio was due to the increase in non-performing loans (NPL) to the business sector[9].

21. Non-performing business loans (i.e. loans that are impaired or more than 90 days in arrears but well secured) comprised around 4 per cent of banks' total business loans in December 2009, increased from a little under 1 per cent during 2005-07. Moreover, the deterioration in non-performing business loans over the past two years has been mainly due to larger incorporated businesses and less for small unincorporated businesses[10].

22. In response to a perceived increase in the default probability among business borrowers, banks have sought to protect their capital by directing their lending towards supposedly less risky undertakings. Banks have generally also increased risk margins and strengthened non-price loan conditions, such as collateral requirements and loan covenants.

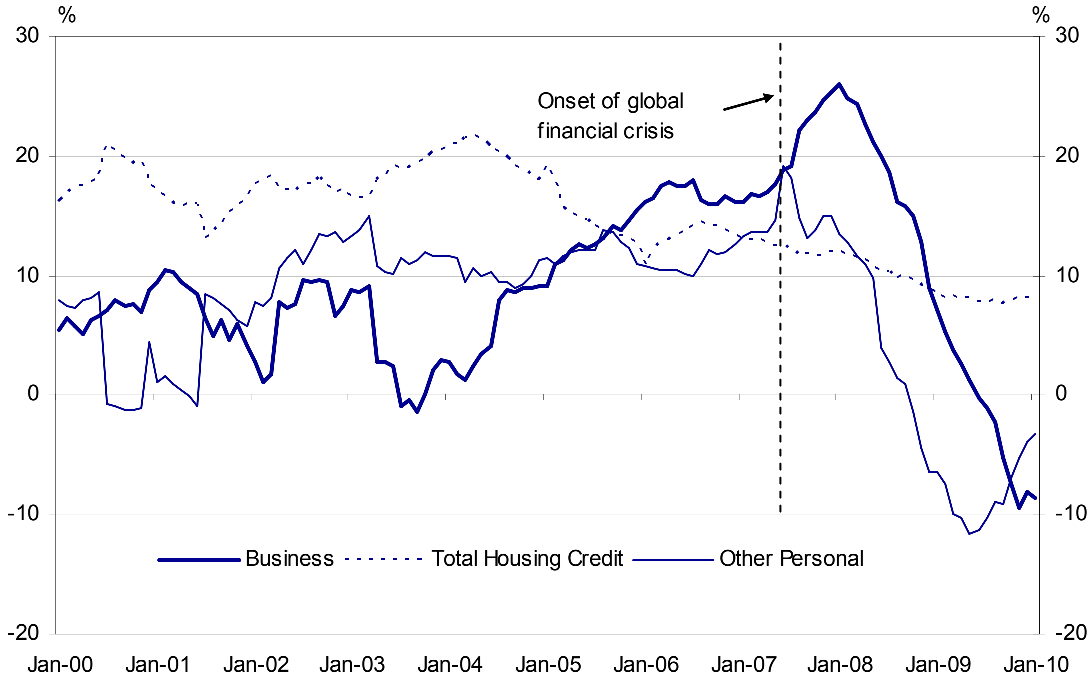
23. On 19 October 2009, the *Australian Financial Review* reported that tough lending criteria have also been imposed since last year, including higher serviceability ratio and lower loan to value ratio. It was indicated that in the case of commercial property banks may only lend up to 65 per cent of the value used to secure a loan, compared to 80 per cent in the past.

24. While housing credit continued to grow over the course of the global financial crisis following historically low interest rates, the Government's First Home Owner Boost and major banks' continued preference for mortgage assets, credit flows to businesses have fallen significantly (Figure 6). Over the year to December 2009, total housing credit grew 8.1 per cent, while business credit fell by -8.1 per cent.

[9] RBA 2010, *Financial Stability Review March 2010*, page 19-20.
[10] RBA 2010, *Submission to the Inquiry into Access of Small Business to Finance* , March 2010, page 4.

Figure 6: Credit by sector

Year-ended percentage change



Source: *RBA Statistical Table F05.*

25. Bank business credit fell at an annualised rate of -10 per cent over the six months to January 2010, compared to -4.7 per cent over the six months to July 2009. In contrast to business credit, bank lending to households has remained resilient and is currently growing at an annualised rate of 11 per cent over the six months to January 2010, compared to 10 per cent over the six months to July 2009.

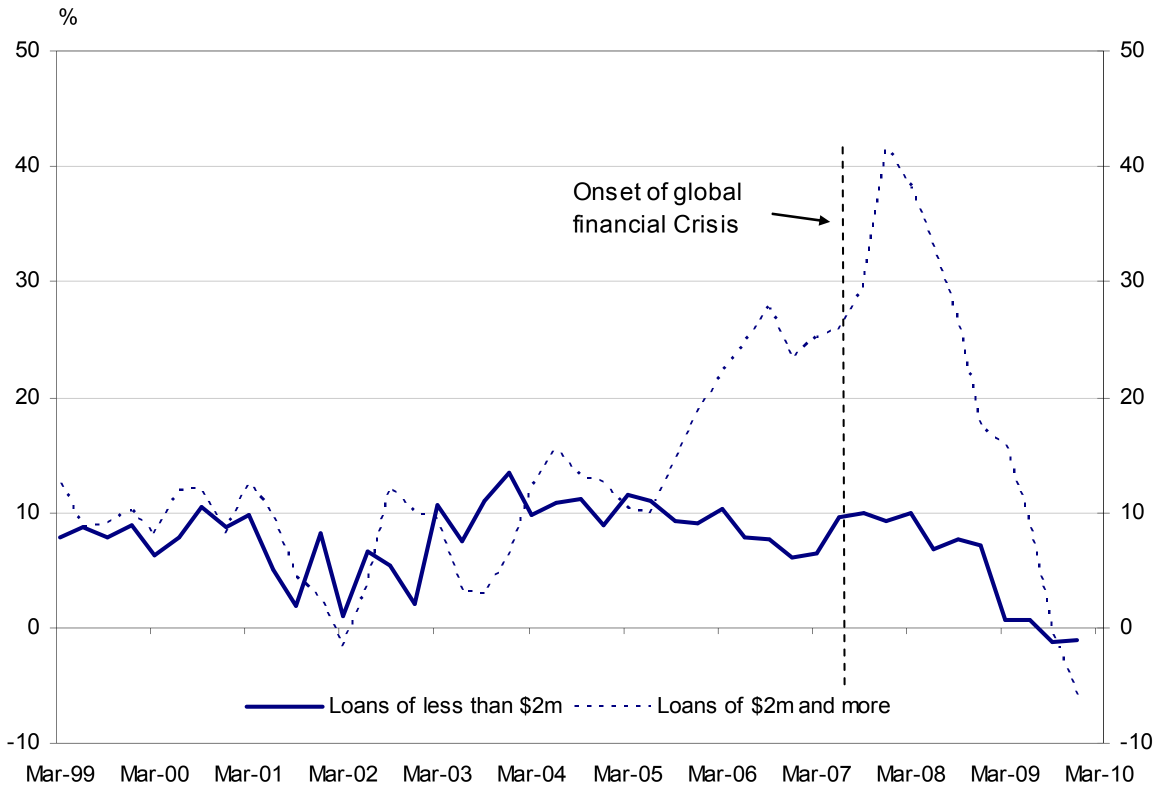
26. As the cost of intermediated finance increased since the crisis, larger businesses elected to diversify their funding by deleveraging their intermediated finance and instead increasing their non-intermediated debt such as corporate bonds and equity issuance. As a source of external funds, the net amount of equity raised by large corporations was equivalent to 6 per cent of GDP, up from an average of 2.5 per cent over the last decade. Corporate bond issuance also picked up from around $12 billion in 2008 to $30 billion in 2009[11].

27. At the same time credit flow to small business has fallen significantly as shown in Figure 7. Bank lending to small business (i.e. total credit outstanding for loans of less than $2 million) has recorded negative annual growth in the September and December quarter of 2009, the first time it has contracted over a 12 month period since the series began in 1994.

[11] RBA, *Op. cit.*, page 49-50.

Figure 7: Bank lending to large and small business

Year-ended percentage change

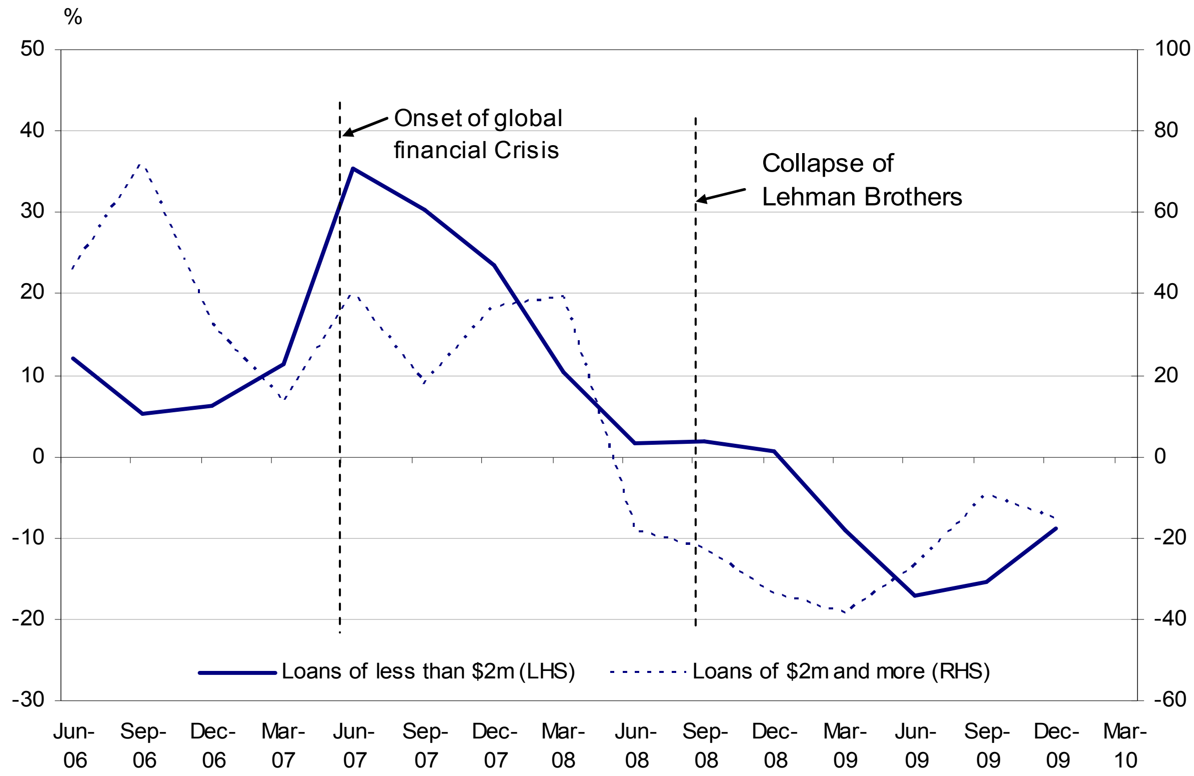


Source: *RBA Statistical Table D8.*

28. New credit approvals to small businesses have fallen since the onset of crisis. Figure 8 shows that year-ended growth for new bank lending to small businesses has fallen from a peak of 35.3 per cent in June quarter 2007 to 2.0 percent in September quarter 2008. After the collapse of Lehman Brothers in September 2008, new credit approvals fell to a trough of -17.0 per cent in June quarter 2009 before recovering to -8.9 per cent in December quarter 2009.

Figure 8: New bank lending approvals to large and small business

Year-ended percentage change



Source: *RBA Statistical Table D8.*

29. We are not able to discern from the above RBA data whether the fall in business credit to small business is mainly due to the lack of credit demand from businesses, or businesses rushing to reduce their leverage by paying off their existing loans, or more importantly due to credit rationing from banks.

30. However, the significant fall in small business lending and new credit approvals especially since the collapse of Lehman Brothers clearly point to the fact that major banks have tried to ensure their profitability and minimise asset risks by tightening their lending criteria and repricing existing loans at the expense of small business borrowers. Credit rationing on small business borrowers has had a detrimental impact on the ability of small business to invest, grow and employ given the limited choices they have to fund their operations.

31. This argument is further supported by the National Australia Bank's head of business banking Mr. Joseph Healy's statement in an interview with the *Australian Financial Review* on 18 February 2010. He stated that:

> "banking systems predilection for home loans was partly responsible for the lack of credit to small business and posed a long term risks for economy.

> "A banking system which allocates capital away from the most productive areas of the economy – business – is ultimately bad for growth, bad for competition, bad for jobs, bad for business and in the end bad for Australia.
>
> "…international banking rules, known as Basel II, contributed to banks' preference for lending for mortgages because they must hold five times more capital to support the same size of loan to a business."

32. While lending to home owners has continued to grow over 2008 and 2009, small business owners have complained about the difficulty to access finance from banks, even with solid lending proposals. This difficulty has also prompted some small business owners to put off business expansion and capital expenditure plans.

33. In the March quarter of 2009 and 2010, ACCI polled businesses on how changes in bank lending criteria over the past six months have impacted on business capital expenditure (CAPEX) plans and working capital or ongoing operating expenses.

34. Table 1 shows that 25.4 per cent of respondents reported that changes in bank lending criteria negatively affect their capital expenditure plans in March 2010, an increase from 22.9 per cent reported a year earlier.

Table 1: ACCI survey responses – Impact on CAPEX

Percent of Responses

	March 2009	March 2010
Major negative impact – greater than 10% reduction	10.2	11.2
Negative impact – up to 10% reduction	12.7	14.2
No impact	66.8	60.2
Positive impact – up to 10% increase	1.8	0.8
Major positive impact – greater than 10% increase	1.8	2.0
Not planning any investment	6.7	11.7

Note: March 2009 survey had 283 respondents while March 2010 survey had 394 respondents.

35. Moreover, Table 2 shows that the percentage of businesses reporting a negative impact of tightening in bank lending criteria on their working capital has increased from 20.1 per cent in March 2009 to 26.0 per cent in March 2010.

Table 2: ACCI survey responses – Impact on working capital

Percent of Responses

	March 2009	March 2010
Negative impact	20.1	26.0
No impact	78.1	71.1
Positive impact	1.8	2.9

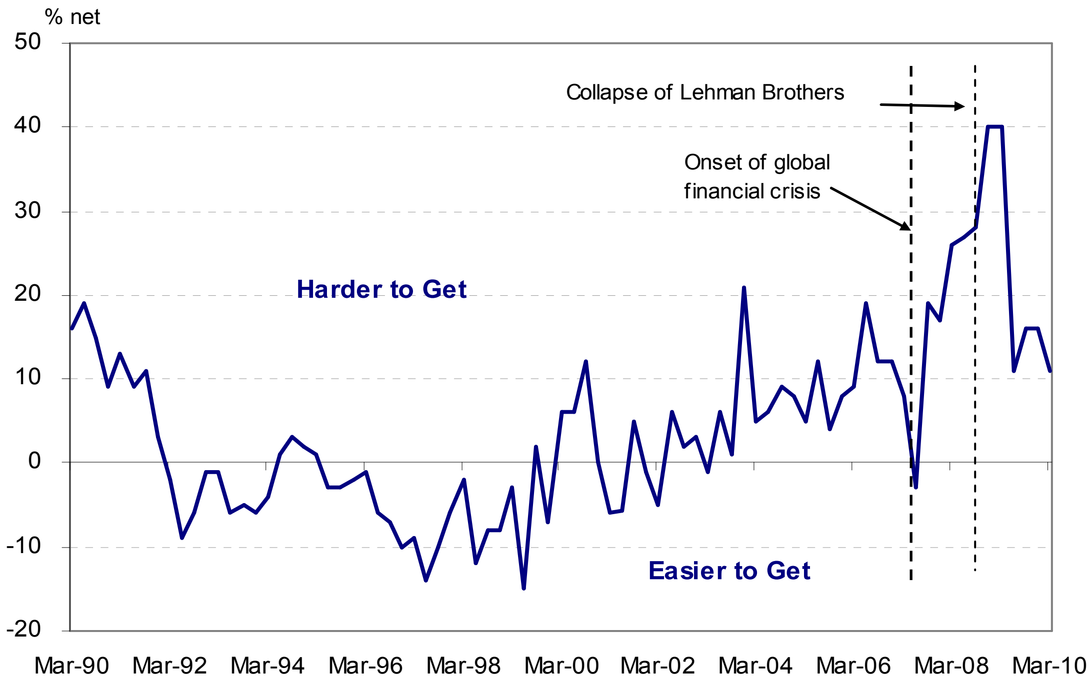
Note: See Table 1.

36. The above tables clearly demonstrate that while the economy begins to recover, more businesses are reporting the negative impact of difficulties in obtaining finance on their investment plans as well as their normal operating expenses.

37. The *ACCI – Westpac Survey of Industrial Trends* also found that more manufacturers are reporting that finance is harder to get since the onset of the global financial crisis. Figure 9 indicates that the net indicator of *Availability of Finance* reached a peak of +40 per cent in the December quarter 2008 and March quarter 2009, significantly above its decade average of +10 per cent. In the December quarter of 2008, 45 per cent of manufacturers reported finance are harder to get compared to three months earlier while only 5 per cent of respondents indicated that finance are easier to get.

38. While conditions have improved since the June quarter of 2009, the net balance for this indicator remains above its decade average.

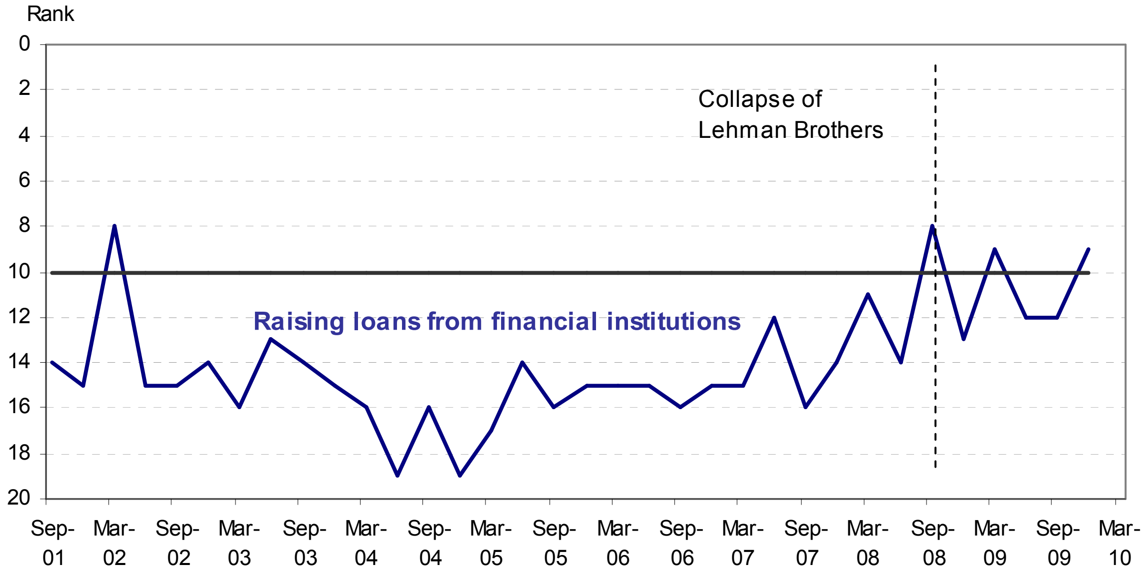
Figure 9: ACCI survey - Availability of finance



Source: *ACCI – Westpac Survey of Industrial Trends,* March 2010.

39. Figure 10 shows that *Raising Loans from Finance Institutions* has become amongst the top ten constraints for small business investment in plant and equipment during the September quarter 2008, March quarter 2009 and December quarter 2009. The last time this indicator entered into top ten was in the March quarter of 2002.

Figure 10: Selected constraint on small business investment



Source: *ACCI Small Business Survey,* February 2010.

40. Similar issues are also highlighted in the PricewaterhouseCoopers October 2009 *Private Business Barometer*. The survey, which surveyed 758 businesses with turnover of between $10 million and $100 million during August and September 2009, reported that private businesses are expanding but their growth plans are constrained by tight lending conditions, in particular:

a. more than 61 per cent of businesses have their debt facility reviewed by lenders during the past six months, with 45.4 per cent of respondents had their loans re-priced;

b. 39 per cent of respondents indicated that the cost of debt was their main difficulty in raising capital, and a further 23.9 per cent said availability of credit was their biggest capital-raising challenge;

c. 81.7 percent of businesses indicated that availability of credit could prevent them meeting their business growth targets in the next year;

d. 30.7 percent of businesses suggested that the cost of debt could also hamper their ability meet their targets in the next 12 months; and

e. the average debt to asset ratio has fallen from 41.3 per cent in February 2007 to 31.2 per cent in August and September 2009.

41. According to the *Financial Ombudsman Service 2008-09 Annual Review*, new credit disputes increased by 36.0 per cent from 4,944 cases in 2007-08 to 6,731 cases in 2008-09. The number of business finance disputes rose 31.8 per cent from 264 cases in 2007-08 to 348 cases in 2008-09. Of the disputes received about credit, the most frequently raised cause of dispute (31 per cent) concerned a decision by

the financial services provider and the biggest single cause concerned the application of break costs to fixed rate and business loans. The vast majority (90 per cent) of credit disputes are related to credit provided by banks[12].

42. The following are some selected case studies provided by ACCI members and business owners which highlight the difficulties in obtaining finance from major lenders currently faced by small business borrowers, even in cases where small business owners having a solid lending proposal. It is worth noting that there is no statistical gathering of data which records instances of declined credit applications by businesses. Accordingly, we rely on case studies to help illustrate examples of seemingly strong lending applications which have not met bank credit standards. The following two case studies are just two such instances[13].

a. **Case Study A[14]**: Business A is a SME incorporated in 1997 with three shareholders governed by a board of six. It provides engineering products and services. Sales and profits have increased over recent years including solid profit performance over the year to June 2009.

   It recently received a $2.8m order from a leading Australian engineering contractor for 3 treatment plants. The company is required to put up a bank guarantees (BG) of 10% for delivery and 12 months warranty in order to receive the 50% deposit with order. The company approached one of the major banks (Bank Y) Business Bank Manager with its current financial position and forecast and requested Bank Y to cover the $160,000 for the BG for 7 days until the company received the $800,000 deposit. On receipt of the monies, Business A would then place the $160,000 on deposit at Bank Y to cover the contingent liability of the BG until they expired or returned.

   After discussing with Bank Y credit manager, the Business Bank Manager rejected the credit request. In response, Business A directors and shareholders were required to advance money to the company at 12% and the BG were issued and delivered to the customer. Currently, $160,000 is in a Bank Y deposit account earning about 4% interest.

b. **Case Study B:** Business B took over a business in 2006 with a $500,000 turnover per annum and in 2009/10 the turnover is estimated to be $2.2m. Given the business is growing and expenses have increased due to expansion, Business B has applied for additional credit facility from Bank Z that it has been dealing with for the past 13 years. However Bank

[12] Financial Service Ombudsman 2009, *2008-09 Annual Review*, page 32.

[13] For other case studies on small business owner experience, please refer to individual submissions by ACCI members. A list of ACCI members is provided from page 34.

[14] In order to protect the privacy of the business owners, the industry this business is in has been modified. However all the financial information remained unchanged.

Z could not see Business B's growth prospect and have withheld from increasing its overdraft limit, line of credit and credit card to assist with paying the expenses. This has caused a significant cash flow problem for Business B.

43. Above case studies highlight examples where small business owners are facing significant difficulties in accessing finance from major banks for business expansion, investment and short-term cash flow assistance. These difficulties even occurred when the customer had a long established relationship and a history of meeting commitments. Our business feedback indicates these are consistent problems amongst many small and medium sized enterprises.

44. It is worth noting that for some small business owners, who have turnover of less than $2m and are in debt to the tax office, the Australian Tax Office has been able to provide relief to many taxpayers by providing deferred payment arrangements, thus helping many small businesses where more inflexible arrangements by the lenders have placed them under pressure[15].

45. ACCI is also concerned that difficulties in obtaining finance may have been worsened by the declining risk assessment skills within the banks. Small business lending is highly specialised and it is not generic like providing housing finance. Moreover it is often not assisted by the transparency and disclosure requirements which help risk assessment in lending to larger businesses. It relies on a skill set which has diminished in the Australian banking sector, including understanding cash flow and the impact of changing market and local conditions, but most importantly knowing and understanding the customer.

46. In a recent poll conducted by ACCI during March 2010, 34.0 per cent of the 215 business respondents reported that their business bankers do not have adequate understanding of their business' cash flows and its ability to service any current or prospective loan obligations.

47. The deterioration in business managers risks assessment not only constrains the ability of banks to make the most out of small business lending, it also hinders the ability of small business to access required finance when business circumstances changes, especially in the current environment where the risk appetite of banks remains subdued but small businesses see future growth prospect in their business.

[15] During 2009, the Australian Tax Office has provided some assistance to small business struggling with debt through some initiatives including the 12-month general interest charge-free payment arrangement for activity statement debt, the interest-free deferral of the payment due date on activity statement liabilities and cash flow relief for business with PAYG instalments.

48. Small business lending can be a profitable exercise for banks. However, failure to devote resources and skills in this area in favour of typical house lending has seen a foregone business opportunity.

5. BANKING COMPETITION

49. Since the onset of the global financial crisis, competition in Australian banking system has diminished significantly as most of the non-bank financial institutions that relied on the securitisation market and foreign banks have exited or reduced lending in domestic markets. There is also the impact of more recent merger and acquisition activity.

50. Reflecting these developments, the major banks have increased their share of mortgage market from 57 per cent in August 2007 to 74 per cent in August 2009; while the share of foreign banks fell from 8 per cent to 5 per cent and non-bank lenders' share fell from 15 per cent to 11 per cent[16].

51. Moreover, the major banks have increased their market share in business lending, accounting for around 75 per cent of lending to unincorporated businesses and around two-thirds of total business credit[17].

52. Richardson (2010) estimated that the largest four banks alone make an underlying profits of around $35 billion before tax in 2009, of which $20 billion per annum in his view is likely to reflect the banks' monopoly power over the Australian payments system[18].

Table 3: Big four banks profits in recent years

	Year to			
	Sep 2006	Sep 2007	Sep 2008	Sep 2009
Pre-tax profit ($m)	23,043	25,398	18,856	22,096
Bad and doubtful debt provisions ($m)	1,801	2,278	6,675	12,993
Underlying profit ($m)	24,844	27,676	25,531	35,089
Pre-tax profit (% of GDP)	2.38	2.43	1.67	1.84
Bad and doubtful debt (% of GDP)	0.19	0.22	0.59	1.08
Underlying profit (% of GDP)	2.57	2.65	2.26	2.91

Source: Richardson (2010), page 4.

53. Table 3 shows that 2009 was a record year for major banks with an underlying profit of $35.1billion. This tranlates to 26.4 per cent return on the banks' shareholders equity of $133.1billion. According to Richardson:

[16] Australian Government 2009, "Australia as a financial centre: Building on our strengths", Report by the Australian Financial Forum, November 2009.
[17] RBA 2010, *Submission to the Inquiry into Access of Small Business to Finance* , March 2010, page 5.
[18] Richardson, D. 2010, "A licence to print money: bank profits in Australia", *The Australian Institute Policy Brief No. 10*, March 2010, page 1.

> "The rates of return earned by the banks (26.4 per cent using pre-tax underlying profit) can be compared with the rates of return earned elsewhere in the economy, which are estimated at approximately six to seven per cent. The average increase in the ASX accumulation index since December 1979 gives a figure of 12.3 per cent for big companies in general. However, as these figures include the banks' results, they are higher than they might otherwise be.
>
> "A second interesting comparison can be made with the alternative uses of their capital that other investors have to consider. The risk-free alternative use of capital can be taken to be represented by the 10-year government bond rate, which was 5.56 per cent in January 2010 and has averaged 5.65 per cent since January 2000. Adding a reasonable margin for risk implies a target rate of return at around the eight to nine per cent level.
>
> "These figures suggest that the underlying rate of return on equity in banks is at least 15 per cent higher than it might be in a truly competitive market, from which it can be inferred that the monopoly profits of the big four banks are around $20 billion, close to half the Commonwealth Government's total GST collections in 2008–09 and well over the $15.8 billion collected in fuel excise."[19]

54. Other studies on bank competition in Australia also found that Australia's bank revenues appeared to be earned under monopoly or conjectural short run oligopoly conditions for the period between 1998 and 2005, as the Australian banking sector is dominated by a small number of large banks[20].

55. According to a recent Boston Consulting Group (BCG) report, Australia's banking industries achived an above-average total shareholder return (TSR) of 61.5 per cent in 2009. Australia had the highest average annual TSR of 9.2 per cent from 2005 to 2009[21].

56. For the first time, each of the largest four banks in Australia ranked among the 30 largest banks in the world[22].

57. For a third consecutive year, Australia together with Canada and Spain had the most profitable banking sectors among the ten major markets in the world. In 2009, CBA was among the top ten large-caps banks with an estimated alpha of 33.9 percent, the second best peformer after Goldman Sachs. This estimate indicates that CBA's had a 33.9 per cent risk-adjusted excess return on investment above market prediction[23].

58. ACCI fully supports and acknowledges the requirement for a strong and profitable banking sector. Indeed the stability of the sector relative to international developments helped secure our response to the global financial

[19] *Ibid.*, page 6-7.
[20] Chan et al., 2007 "Bank competition in New Zealand and Australia", Paper presented at the 12th FINSIA-Melbourne Centre for Financial Studies Banking and Finance Conference, 24-25 September 2007.
[21] Boston Consulting Group (BSG) 2010, *After the Storm: Creating Value in Banking 2010*, February 2010, Massachusetts, USA, page 14.
[22] *Ibid.*, page 19.
[23] *Ibid.*, page 20-21.

crisis and emerge more quickly and less affected than all other advanced economies. Nevertheless, we are concerned about diminishing competition in retail banking and the likely detrimental impact on business borrowers.

59. In part competitive conditions may improve as the economy further recovers providing the opportunity for a larger number of lenders to re-enter the market including those servicing SMEs.

6. ANTICIPATED REGULATORY CHANGES

60. In December 2009, the Basel Committee on Banking Supervision[24] has announced a series of proposals aim at making the global banking sytem more resilient. The measures are meant to strike a balance between financial innovation and sustainable growth, with five main proposals to:

a. introduce more stringent measurement for both market and credit risk to corect the faulty or misguided methods that proved problematic during the crisis;

b. restrict the capital counted as Tier 1 to strengthen the capital base;

c. impose a maximum leverage ratio to prevent banks from taking on risks that could undermine not only single institutions but entire banking setcors and economies;

d. set a global standard for minimum liquid-asset holdings which includes both short- and long-term liquidity-coverage ratios; and

e. account for procycality and systematic risk by requiring that banks build up capital buffers during good times which could be drawn upon during periods of stress[25].

61. The impact assessment of the above proposals will be carried out in the first half of 2010. The fully calibrated set of standards will be developed by the end of 2010 and to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by the end of 2012[26].

62. While the above proposals will improve the stability of the banking system, they are certain to lead to smaller banks' balance sheet and lower profits.

[24] This Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision.
[25] *Ibid.*, page 10.
[26] http://www.bis.org/press/p091217.htm accessed on 26 March 2010.

63. The BCG report, which modelled the potential effects of the above proposals on 32 large banks across 12 countries – including Australia's largest four banks, estimated that[27]:

a. the Tier 1 ratios of the 32 banks would decline by about 50 per cent due to a stricter definition of eligible Tier 1 capital. The exclusion of certain items, in particular hybrid instruments, would reduce the Tier 1 ratio by 35 to 40 per cent;

b. the 32 banks would need to increase their core capital by 15 to 40 per cent, or US$280 billion to US$650 billion (assuming they preserve their current balance sheets), in order to preserve their Tier 1 ratios in the range of 6 to 8 per cent; and

c. the impact of regulations on both capital and liquidity will vary widely by country.

64. The BCG report highlighted that banks around the world will need to increase prices and cut costs to offset the impact of the anticipated regulatory changes. Nonetheless, the new regulations will still pose a dilemma:

> "…Banks will need to raise more capital in order to maintain their existing business models, or they will have to limit the scope of their activities to stay within the confines of the remaining capital base. The former will dilute current shareholdings, while the latter will impair revenues and profits. Under either scenario, investors will see a significant decline in the value of their shares. Stock prices could fall by about 12 to 25 per cent as a result of the dilution of shares if banks were to raise the amount of capital described above [US$280billion to US$650billion]…" [28]

65. BCG estimated that Australian and Japanese banks will need to raise US$40 billion to US$90 billion of additional Tier 1 capital, in order to reach the 6 to 8 percent of requirement threshold.

66. ACCI is concerned that the above anticipated changes in bank regulations will further put small business borrowers in an unfair advantage compared to mortgage borrowers and larger corporate, with the flow on impact of higher funding costs and bank charges as well as further tightening in non-price lending requirements imposed on small business sector.

7. INTERNATIONAL EXPERIENCE

67. Unlike other economies such as the US, Canada, Japan, Korea and Singapore, Australia currently does not have a public or private organisation(s) mandated to provide financial support or assistance to SMEs. This section provides some

[27] BCG, *Op. cit.,* page 10.
[28] *Ibid.*, page 10.

international policies, practices and strategies that are aimed to enhance access to small business finance.

7.1 USA

68. The *Small Business Administration* (SBA) is a US government agency that provides support to small business since 1953. The SBA is created under the *Small Business Act* of July 30, 1953. Its function was to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns". The charter also stipulated that the SBA would ensure small businesses a "fair proportion" of government contracts and sales of surplus property[29].

69. However, the most visible element of SBA is the loan programs it administers. The SBA does not make loans directly to small businesses but does help to educate and prepare the business owner to apply for a loan through a financial institution or bank. The SBA then acts as a guarantor of the bank loan. In some circumstances it also helps to procure loans to victims of natural disasters, works to get government procurement contracts for small businesses, and assists businesses with management, technical and training issues.

70. The following are types of guaranteed loan programs to assist small businesses:

    a. **7(a) Loan Program**: This is SBA's primary and most flexible program that is designed to assist start-ups and existing small businesses. The program is delivered through commercial lending institutions with SBA guarantee;

    b. **504 Fixed Asset Loan Program**: This programme provides long-term, fixed rate financing to acquire fixed assets, such as real estate or equipment, expansion or modernisation. It is delivered by Certified Development Companies (CDCs), which are provate, non-profit corporations set up to contribute to the economic development of their communities;

    c. **Microloan Program**: This program provides small (up to US$35,000) short-term loans for working capital or the purchase of inventory, supplies, furnitures, fixtures, machinery and/or equipment. It is designed for small businesses and not-for-profit child-care centres needing small-scale financing and technical assistance for start-up or expansion and is delivered through specially designated intemediary lenders; and

    d. **Disaster Assistance Loan Program**: This program provides low-interest loans to homeowners, renters, businesses of all sizes and most

[29] Information about the US *Small Business Administration* is available from www.sba.gov.

private non-profit organisations to repair or replace real estate, personal property, machinery and equipment, inventory and business assets that have been damaged or destroyed in a declared disaster.

71. As part of the *American Recovery and Reinvestment Act* following the crisis, the US government has made the following changes to the SBA's existing loan programs[30]:

a. permanently increase maximum loan size for:

i. 7(A) loans from US$2m to US$5m;

ii. 504 loans from US$2m to US$5m for standard borrowers (supporting a total project of US$12.5m), and from US$4m to US$5.5m for manufacturers (supporting a total project of US$13.75m); and

iii. Microloans from US$35,000 to US$50,000.

b. temporarily increase the maximum guarantee on 7(a) loans to 90 percent and eliminate borrower fees in both the 7(a) and 504 programs;

c. temporarily allow small businesses to refinance existing, qualified, owner occupied and small business commercial mortgage into SBA 504 Loan structure. This initiative will temporarily support refinancing for small business owner-occupied commercial real estate (CRE) loans that are maturing in the next few years and help refinance over US$20b each year in CRE that might otherwise be foreclosed or liquidated; and

d. temporarily increase the cap on SBA 7(a) Express loans from US$350,000 to US$1 million to expand access to much-needed working capital and allow more small businesses to take advantage of the streamlined approval process.

7.2 Canada

72. The *Canada Small Business Financing Program* (CSBF-Program) was established under the *Canada Small Business Financing Act* was enacted in April 1999, which build on the success of its predecessor, the *Small Business Loans Act.* The CSBF-Program's objectives are to streamline loan administration, improve its ability to

[30] http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf

achieve cost recovery and to extend financing that would otherwise have been unavailable to small-and medium-size enterprises[31].

73. It seeks to increase the availability of loans for establishing, expanding, modernising and improving small businesses. It does this by encouraging financial institutions to make their financing available to small businesses through risk sharing between lenders and the Canadian government.

74. Under the CSBF-Program:

   a. small businesses operating for profit in Canada, with gross annual revenues of CAD5 million or less (except for farming businesses which are eligible under a similar program designed specifically for farming industry), are eligible to apply loans for up to a maximum of CAD250,000;

   b. small business must apply for a loan at a financial institution of its choice;

   c. the Canadian government guarantees 85 per cent of loans made by eligible financial institutions to qualifying businesses; and

   d. financial institutions with a portfolio of eligible loans above CAD500,000 can claim reimbursement on losses of up to 10 per cent of the value of their portfolio.

75. After the crisis, the Canadian government announced further boost to the CSBF-Program under its 2009 Budget[32]. The Canadian government increased the maximum loan amount a small business can access under the CSBF-Program for loans made after 31 March 2009, from CAD250,000 to CAD500,000 for any one business, of which no more than CAD350,000 can be used for purchasing leasehold improvements or improving leased property and purchasing or improving new or used equipment.

76. The Canadian government also increased the limit of loss reimbursement from 10 per cent to 12 percent of the value of financial institutions' portfolio for loans made after 31 March 2009. Paperwork associated with the CSBF-program has also been reduced.

7.3 Japan

77. *Japan Finance Corporation* (JFC) is a public corporation wholly owned by the Japanese government, established on October 1, 2008, as the result of the integration of National Life Finance Corporation (NLFC), Agriculture, Forestry

[31] More information is available from http://www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/Home

[32] Department of Finance Canada 2009, *Canada's Economic Action Plan: Budget* 2009, 27 January 2009, page 83.

and Fisheries Finance Corporation (AFC), Japan Finance Corporation for Small and Medium Enterprise (JASME) and Japan Bank for International Cooperation (JBIC).

78. At present, *JFC Micro Business and Individual Unit* (JFC-Micro) is one of the units of JFC that specialises in financing for micro and small enterprises (MSEs)[33]. The following are the characteristics of JFC-Micro business loans:

a. JFC-Micro business loans are available to MSEs in almost any industry;

b. New start-up companies are eligible for JFC-Micro business loans;

c. JFC-Micro has some loans which do not require *any* guarantors or collateral, and some loans which do not require third-party guarantors or collateral; and

d. JFC-Micro offers long term loans (up to 20 years) with fixed interest rate. The maxium loan amount ranged from ¥15 million to ¥720 million depending on types of loan and industry.

79. Another division under the JFC is the *JFC Small and Medium Enterprise Unit* (SME Unit) which has taken over the responsibilities and operations of the JASME, a government-affiliated financial institution originally established in August 1953[34].

80. Supplementing private financial institutions, the SME Unit provides a stable supply of long-term funds as part of its overall mission to support the growth and development of SMEs.

81. The following are some of the SME Unit loan programs designed to assist SME businesses who have encountered difficulties to access loans from private financial institutions:

a. the SME Unit specialises in long term funds that private financial institutions have difficulty providing. Approximately 60 per cent of the SME Unit's loans have lending periods longer than five years with fixed interest rates that make it easier to map out repayment schedules; and

b. the SME Unit offers a variety of Special-Purpose Loans designed to facilitate the government policy guidance by channelling funds into targeted sectors, in which funding remains insufficient when relying solely on private financial institutions. This includes:

[33] http://www.k.jfc.go.jp/pfce/loans/index.html
[34] http://www.c.jfc.go.jp/indexe.html

i. the "Loans to Foster Growth of New Businesses" which support SMEs taking on businesses with high growth potential; and

ii. the "Corporate Revitalisation Loans" which support SMEs that are endeavouring to revitalise their businesses, pursue corporate rehabilitation and implement business sucession.

7.4 Korea

82. The *Industrial Bank of Korea* (IBK) was established in 1961 to promote and provide assistance to SMEs under the *Industrial Bank of Korea Act* and has been listed at the Korean Stock Exchange. The Korean government holds approximately 76 per cent of the Bank's share as of the end of 2009[35].

83. The *Industrial Bank of Korea Act* stipulates that IBK lends more than 70 per cent of its assets to SMEs. In 2008, IBK extended loans amounting to KRW 78,501 billion, or 80.6 per cent of its total loan amounts, to SMEs and captured 17.8 per cent of the total SME loan market of Korea.

84. Aside from providing essential capital to SMEs who are experiencing financial difficulties, IBK also aims to enhance the efficiency of SME financing by collaborating with the Korean government in order to reinforce the laws and regulations that are more SME-friendly.

85. Year 2008 was especially challenging for the majority of Korea's small and medium sized corporations, due to the downturn in the global economy and volatile foreign exchange rates. IBK has tried to meet as many SMEs' financing needs as possible through Korean government subsidies or programs such as "Municipal Government Loans", "Resolution for SMEs' Financing Difficulty", and "Special Support for SME with Growth Potential".

86. Besides the subsidy from the government, IBK has developed diverse financial instruments to provide urgent capital to SMEs, including:

a. SGI Cycle Loan that provides a simultaneous loan offering with a sales agreement;

b. Commodity Procurement Loan that provides a loan offering for purchasing commodities;

c. Growth Potential Loan which provides a loan for innovative SMEs;

[35] All the information is available from http://english.ibk.co.kr/en/home.html

d. Start-up Loan which provides a loan for young entrepreneurs who start out their own businesses; and

e. SME Liquidity Loan which provides urgent credit facility supported by the Korea Credit Guarantee Fund and KIBO Technology Fund.

87. Despite the global financial crisis which put pressure on asset quality, IBK succeeded in maintaining sound asset quality with its corporate banking delinquency rate remaining below 1.0 per cent in 2008.

88. An important part of the IBK's effort to enhance SME asset quality is its Corporate Physician Program designed to strengthen relationship management and to promote the mutual success of both IBK and its client firms. Under the program, IBK carries out ongoing monitoring of SMEs clients, conducts management audits, and extends timely financial support as necessary.

89. The program is implemented through Corporate-Relationship Managers (Co-RMs), who are deployed to branches to share their expertise. IBK selects Co-RMs from among retired general managers of the branches, who have accumulated experience and know-how through many years of service at the IBK. The Co-RM system is helping its clients to become more competitive, while at the same time enhancing IBK's asset quality.

7.5 Singapore

90. The *Standards, Productivity and Innovation Board*, also known as SPRING Singapore, is a statutory board under the *Ministry of Trade and Industry of Singapore*. It provides loans and credit guarantee schemes to assist businesses incorporated in Singapore to raise capital. It is important to note that SPRING, which similar to the US *Small Business Administration*, is not a financial institution.

91. The following are some of SPRING's financial assistance programs developed in collaboration with private financial institutions:

a. **Bridging Loan Program**: This program provides loans up to SG$2 million to locally owned or foreign SMEs for working capital purposes, including unsecured credit. The government's share of lending risk is 50 per cent[36];

b. **Local Enterprise Finance Scheme**: This program provides loans for the purchase of equipment and assets of up to SG$15 million to all locally

[36] http://www.spring.gov.sg/EnterpriseIndustry/FS/Pages/bridging-loan-programme.aspx#overview

owned companies. The government's share of lending risk is 70 per cent[37]; and

c. **Micro Loan Program**: This program provides loans of up to SG$100,000 for local SMEs with 10 or less employees. The fund can be used for daily operations and for automating or upgrading factory and equipment. The government's share of default risk is 70 per cent[38].

8. ACCI RECOMMENDATIONS

92. Loans to the small business sector are especially vital to Australian economy as they employ nearly 50 per cent of Australia's private sector workforce. Small businesses experience difficulties in accessing intermediated finance due to informational asymmetries between small firms and banks. In some cases the problem of informational asymmetries may be so pronounced that even profitable opportunities are not financed.

93. Since the onset of global financial crisis, this problem has been exacerbated with major banks becoming more risk averse and overly conservative in their small business lending. Accordingly, banks have increased their risk margins for small business loans and tightened their standards and terms for new loans through lower loan-to-valuation ratios, stricter collateral requirements and higher interest coverage ratio. This often occurs as lenders have not properly understood or recognised: the subject business; its established trading record; and the real level of risk exposure associated with its operation.

94. Moreover, the decline in retail banking competition following more recent merger and acquisition activity and reduced lending by smaller banks and non-bank financial institutions has further limited the avenue for small business to access finance for working capital, investment and business expansion.

95. While some businesses are being denied credit due to their poor repayment history, ACCI is concerned that even businesses with excellent repayment records and solid lending proposals are finding credit restricted due to weakened balance sheets, reduced revenues or cash flows, and/or falling real estate collateral values. Furthermore tighter credit standards imposed by major lenders may have caused some businesses to delay their plans for business expansion even where this course was likely to lead to greater profitability.

96. ACCI is not however advocating that banks should fund riskier or marginal lending proposals without robust risk assessment. Instead they need to be better

[37] http://www.spring.gov.sg/enterpriseindustry/fs/pages/local-enterprise-finance-scheme.aspx
[38] http://www.spring.gov.sg/enterpriseindustry/fs/pages/micro-loan-programme.aspx

informed and skilled in making such assessments rather than applying rigid credit rules which ignore the strength of the underlying proposal.

97. The small business sector, as the engine of the Australian economy, plays a crucial role in ensuring the durability and sustainability of Australian economic recovery and to promote future economic growth.

98. In order to assist small business access to credit, the following are ACCI specific recommendations:

   i. **Promote competition:** The Government needs to ensure that competition in Australian retail banking system is not further eroded by future merger and acquisition activity. Nonetheless, ACCI acknowledges competitive conditions may improve as the economy further recovers providing the opportunity for a larger number of lenders to re-enter the market including those servicing SMEs;

   ii. **Further examination by the Productivity Commission:** In addition to this Senate inquiry process, the Government should commission Productivity Commission to conduct an inquiry to examine the degree of competition in the provision of SME financing. This study should examine:

      a. the impact of an increasing number of participants in lending markets;

      b. the implication of repricing of risk to businesses;

      c. the changes that have occurred in the cost and availability of finance to SMEs over time; and

      d. international experiences in assisting credit flows to SMEs and their advantages and disavantages if applied in Australia.

   iii. **Monitor the impact of international regulatory changes:** In the face of anticipated regulatory changes by banking supervision agencies, policymakers need to be aware that supervision and examination policies may unintentionally impede small business lending practices;

   iv. **Policymakers need to be aware of SME impact:** While banks should be prudent when making lending decision, policymakers need to convey a simple message – banks should strive to ensure credit flows to creditworthy small business borrowers.

   v. **Banks must improve lending skills:** Australian banks should implement education and training programs to improve risk assessment skills amongst the business lending managers and credit departments, in particular focussing on small businesses and start-up lending;

vi. **Policymakers should continue and improve liaison with business:** The RBA and/or related government departments or agencies should conduct regular forums to better understand difficulties faced by small business and this will inform additional efforts designed to help the small business sector. Access to better data on finance availability issues is also important including where possible, some measurement of declined applications and related reasoning; and

vii. **Government to note international programs dealing with SME finance availability:** The Government needs to note other international policies, practices and strategies that are designed to assist small business in obtaining finance when private lenders are not able to provide the required capital. These have been extensive in many advanced economies.

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