Office of the Chief Executive
Alex Malley, FCPA
CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia
GPO Box 2820
Melbourne VIC 3001 Australia

T +61 3 9606 9689
W www.cpaaustralia.com.au
E **alex.malley@**
cpaaustralia.com.au

9 April 2010

The Secretary
Senate Economics References Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

By email economics.sen@aph.gov.au

Dear Sir/Madam

Inquiry into Access of Small Business to Finance

CPA Australia welcomes the opportunity to provide input into the Senate Economics References Committee's *Inquiry into Access of Small Business to Finance.*

CPA Australia represents the diverse interests of more than 129,000 members in over 100 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders. This submission is made not only on behalf of our members, but also for the accounting profession and in the broader public interest.

Overall, the Australian banking system generally performed well during the crisis particularly in comparison to the banking systems of many other countries. The system remained functioning and with little exposure to high risk assets that seem to categorise the banking sectors of other countries. This however does not mean that business lending was not affected. There was and remains a general tightening of credit conditions and a decrease in demand for finance from business, reflecting the current uncertain economic environment.

While the Global Financial Crisis is said to be over, the credit crunch remains. We do not see a return to pre-crisis lending conditions any time soon. However we do not consider such a return is desirable. This view is shared by Dr Henry, Secretary of the Treasury, who stated recently: *'... we do not expect a return to the conditions that existed immediately before the crisis. …The abundance of liquidity and exuberance in global financial markets clearly meant that the price of risk was unsustainable and did not adequately reflect inherent credit risks.'*[1]

In preparing this submission, we sought the views of members who have recent experience in accessing finance via a series of member round tables in four capital cities in Australia. Our members play a very prominent role in assisting SMEs access finance. A detailed account of the views of members is attached to this submission. The key theme to emerge from members is that the relationships between banks and SMEs have been damaged during the crisis. While members generally understood the need for banks to take a more prudent approach to lending in the current economic environment, members expressed the view that banks could needed to improve their transparency and communication on their tighter conditions to business, including providing more notice on such changes.

[1] Henry, K *'The Australian Financial System - Emerging from the Global Financial Crisis'* Address to the Count Financial Canberra Conference 15 March 2010

One initiative that may contribute to improving the relationship between banks and SMEs and reduce the possibility of this relationship being damaged in the future, is for the Australian Bankers' Association (ABA) to consider expanding its existing Code of Banking Practice to include a code of conduct on SME lending. We have passed on this suggestion to the ABA for their consideration accordingly.

The other main observations to emerge from members are:

- banks are still lending, however it seems that secured lending is nearly the only form of new lending that banks are willing to make
- businesses with secured lending facilities have noticed that they have had to increase their level of security
- the increase in information required by banks to obtain a new loan and extra reporting requirements for those with existing loan facilities
- the lack of experience of business bankers, the high turnover of staff and their lack of authority
- the reduction in competition amongst lenders, and
- the economic impact of the downturn and the tighter lending conditions.

The recommendations from our submission are:

- the government work with lending institutions to develop information and education products that:

    - improve small business knowledge of the wide range of financing options that may be available to them
    - help small business choose the mode/s of finance that best suit their needs
    - assist small business understand what they may need to do to attract finance from a wider range of sources.

- the ABA consider amending its existing Code of Banking Practice to include a section on bank lending to SMEs. We suggest that the ABA consider reviewing the Canadian and Irish codes of conduct on lending to SMEs as part of such a process.
- the government or its agencies, investigate whether introducing a Bank Lending Survey measuring changes in demand for debt finance by SMEs as perceived by senior bankers will help the business community understand trends in business lending.
- the government provides further support to small business through subsidised training and information and education products that help to develop the financial management skills.

Should you have any questions regarding this submissions please do not hesitate to contact Gavan Ord on (03)9606 9695 or gavan.ord@cpaaustralia.com.au.

Yours sincerely

Alex Malley FCPA
Chief Executive Officer

cc: G. Ord

Submission to the Senate Economics References Committee inquiry into access of small business to finance

1. General Comments

1.1 Impact of the crisis on SMEs

Small to medium sized-enterprises (SMEs) have to varying degrees been exposed to two different shocks (which reinforce each other), a demand slump or downturn, and a financial shock due to a reluctance to lend.

At a round table gathering of national governments (including Australia) at Turin in March 2009 to discuss the impact of the Global Financial Crisis on SMEs (the gathering was held under the auspices of the of the OECD Working Party on SME and Entrepreneurship), the issues paper[2] prepared from feedback from national governments for the round table summarised the experiences of SMEs globally as follows:

- enterprises in general have strongly reduced their investment projects financed by bank credit
- SME demand for working capital and short-term loans has reduced but not as dramatically as for investment projects
- banks have tightened their lending policies in terms of guarantees, collateral and amounts for all enterprises
- in some countries, banks have substantially increased the cost of credit for all enterprises.

While governments have a role to play in assisting SMEs immediate liquidity issues, ultimately it is a sustainable economic recovery that is the solution to these issues. CPA Australia therefore acknowledges the support the government and its agencies (particularly the Australian Taxation Office) have provided to SMEs to help them manage through the global financial crisis.

1.2 The impact of tighter lending conditions and higher costs on small business

Firstly, we would like to state that we are not critical of a tightening of lending conditions, nor the banks seeking additional security and information. However, such actions do have consequences for small business and therefore the challenge for lenders is to find the balance between imposing suitable lending conditions and giving suitable businesses reasonable access to finance at a cost that reflects the risk of such lending. We believe this balance has not yet been achieved, and a code of conduct on SME lending (discussed later) may help to achieve such a balance.

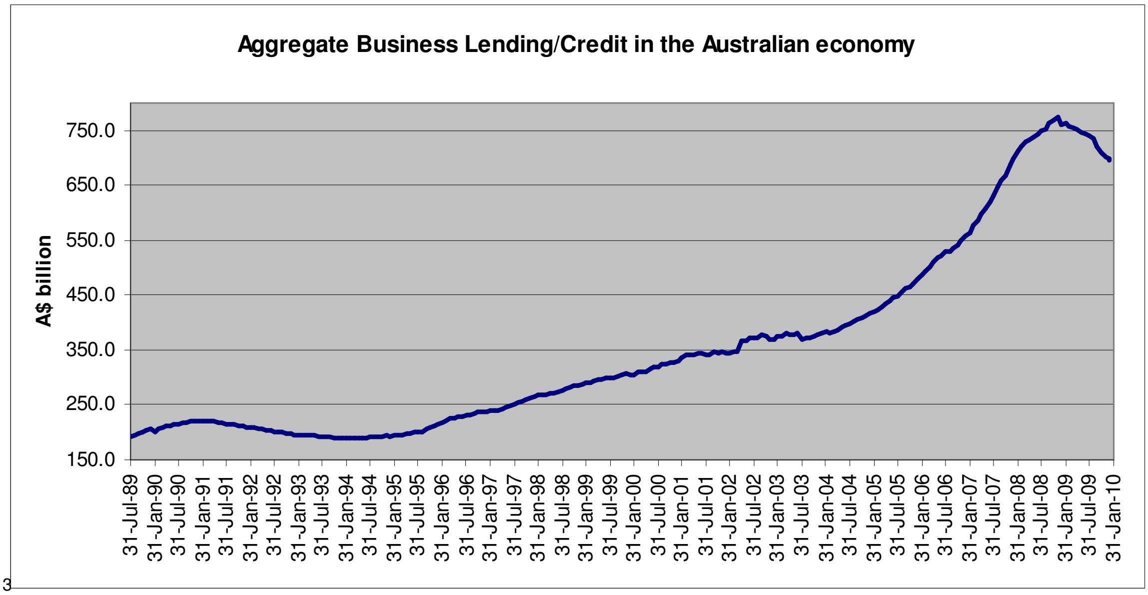
In our view, one major consequence of the speed and (often) lack of warning with which the changed credit conditions (including implementing additional reporting requirements) were imposed is the lack of time many businesses had to adjust their systems to meet the new requirements. This added to the pressure many businesses felt during the crisis and could have been handled better by the banks.

The impact of tighter lending conditions has to be considered in the context that a minority of small businesses have an existing loan. As CPA Australia's Asia-Pacific Small Business Survey of 2009 found, only 20 per cent of Australian small business had an existing loan (instead they rely mainly on the owner's equity and cash from business operations). Hence the tighter credit conditions are unlikely to have had a direct impact on many small businesses, however most would have been affected indirectly in some way, for example a major customer of a small business reducing their purchases because they found it difficult to raise finance to fund such purchases.

1.3 Business borrowing since 1989

The following chart has been developed based on the Reserve Bank of Australia's (RBA) Lending and Credit Aggregates. It shows aggregate business lending/credit in the Australian economy from just before the recession of the early 1990's through to the most recent data from the RBA (January 2010).

[2] '*Turin Round Table on the impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses Issues Paper*' OECD and Intesa Sanpaolo, Turin, Italy, 26 to 27 March 2009



[3]

From our research of RBA, Treasury and Australian Securities Exchange (ASX) information, including the above graph the following observations can be made:

- business lending and credit peaked in the Australian economy at $772.9 billion (seasonally adjusted) in November 2008.
- the total amount of business lending/credit in the economy now sits at approximately $697 billion seasonally adjusted as at January 2010.
- there are many reasons for the decline in the total amount of business lending/credit in the economy including:
    - a decline in demand for credit by business caused by the slow down in the economy (or in anticipation of the slow down in the economy)
    - a decline in demand for credit due to the tightening of lending conditions for business by lenders (possibly leading to businesses delaying seeking finance for fear of rejection)
    - a decline in demand as a result of increased cost of credit. Increased costs may have also encouraged businesses to use excess cash to repay debt
    - large corporates turning to capital raisings ($98.6 billion was raised through secondary raisings on the ASX in 2009, being the highest on record) and using a significant proportion of that funding to repay debt
- in the recession of the early 1990's, business lending/credit peaked in February 1991 and remained below that peak until February 1996.

1.4 Member feedback

Our members play a very prominent role in assisting SMEs (whether as an external adviser or an employee) access finance. Hence we spent considerable time gathering the opinions of members on small business access to finance; mainly through round table discussions held in Canberra, Melbourne, Brisbane and Sydney.

The key theme to emerge from members is that the relationships between banks and SMEs have been damaged during the crisis. Members attributed this mainly to poor communication between banks and SMEs, and banks not giving advanced notice of changes to reporting requirements. The other main observations to emerge from members (many of which relate back to the key theme) are:

[3] Developed by CPA Australia from the Reserve Bank of Australia's Lending and Credit Aggregates (updated 05 March 2010)

1.4.1 *Banks are still lending but such lending is predominately secured lending and the lending conditions are stricter than previously*

The banks are still lending but mostly where the loan is fully secured by a tangible asset and personal guarantees (and in some cases, also key man insurance). Where there is an existing loan, banks are requiring additional security. In summary, members stated that lenders were no longer prepared to provide finance on 'soft' security such as cash flow or goodwill (unsecured finance) - which had been available pre-GFC.

1.4.2 *Banks are requesting increased detailed information from SMEs*

According to members, banks have significantly increased their reporting requirements for both existing and new borrowers in the SME sector and the detail required in such information. The frequency that such information is required has also increased. Where such requests were not inconsistent with loan agreements, members did state that this was first time that much of the additional information requirements were requested.

Members questioned the usefulness of much of the information generated to meet the extra reporting requirements (both to the bank and the business). Members also stated that much of this additional information is not readily available to SMEs from their existing systems, hence it has been difficult for some small businesses to meet such information requirements without the assistance of a professional (thus adding to the costs of obtaining and maintaining a loan).

1.4.3 *Bank staff experience, turnover and authority*

Strong views were expressed by members that the business bankers they deal with are inexperienced and were therefore unlikely to have the necessary skills to appropriately assess credit applications. Members stated that this is adding to the burden on business in securing finance and maintaining finance facilities as they are having to spend extra time providing additional explanations and information on their industry and business which an experienced banker may not normally require. Members also commented that the turnover in business bankers is adding to this burden as this potentially creates a need to re-explain their business to a new person. Regional members expressed concern that bankers in regional areas do not have the authority to assess and authorise loan applications.

1.4.4 *Lack of competition*

Some members believe that the lack of competition from second tier banks, overseas banks and alternative finance providers has given the four majors the whip hand and negatively affected the supply of credit.

1.4.5 *Economic impact of the tightening of credit conditions*

Members raised the impact of the tightening of credit conditions on business and the economy. They were particularly concerned that the higher security requirements would negatively impact the ability of existing businesses and people considering going into business to raise finance (particularly those with a limited asset base). These twin concerns not only effect the ability of existing businesses to grow but also has the potential of reducing the demand for existing businesses (as those considering going into business may have difficulty raising finance), thus decreasing the value of such businesses.

The general conclusion that we draw from the CPA Australia round tables is that the pendulum has swung from the pre-GFC environment where many lenders were too lax with their credit conditions, to the current situation with banks being very strict in their credit conditions.

A detailed summary of the views of members is enclosed in the Attached to this submission.

1.5 Confidence of the SME sector

The CPA Australia's *Asia Pacific Small Business Survey* (conducted in August 2009) and the CPA Australia sponsored Economist Intelligence Unit (EIU) global survey *'Access to finance for the small and medium sized enterprise sector'* (conducted in September 2009) both show that SMEs are growing (particularly in the Asia Pacific and within that region, Malaysia), but not at the same rate as prior to the downturn, and that they are confident about their future growth prospects.

However, it is probably best to describe the mood of SMEs as 'qualified optimism'. While the surveys show SMEs are optimistic about future growth, such optimism is not fully reflected in forecast employment growth and projected investments. In normal circumstances, we would expect planned employment growth and investments to more closely correspond with the levels of business confidence. Such qualified optimism could be a reflection of concern over the robustness of the recovery and the continuance of tight credit conditions.

2. The costs, terms and conditions of finance and changes to lending policies and practices affecting small business

2.1 Tightening of lending conditions

There has been a general tightening of credit conditions and a decrease in demand for finance, reflecting a more uncertain economic environment. The tightening of credit conditions has negatively impacted many small to medium sized businesses because of their lack of access to well-developed financing alternatives to bank finance that large businesses have available (such as equity financing and corporate bonds). On the lack of financing alternatives available to SMEs, Dr Henry, recently stated:
'*Others that don't have access to these financing alternatives* [equity and debt markets, such as corporate bonds] *have been most affected by the tightening in conditions for intermediated credit.'*[4]

Our view that there has been a general tightening of credit conditions is also shared by Dr Henry, who in the same speech stated *'… intermediated credit [loans to business] from the banking sector became more expensive and subject to tighter conditions*'[5] and is reflected in the most recent Sensis SME survey published in March 2010, which stated that 35 percent of small businesses feel it is still difficult to obtain finance.

The view that lending conditions has tightened may appear to be inconsistent with the Reserve Bank of Australia's submission to this inquiry that the **total value of outstanding loans** (we are assuming that graph 1 in the RBA submission refers to the total value of outstanding loans) under $2 million dollars and outstanding loans to unincorporated businesses (the loans that small business are most likely to take out) have remained relatively unchanged in 2009. However tighter lending conditions does not necessarily mean that the value of loans outstanding will decline.

One possible reason for the **lack of decline** in the value of lending associated with SMEs is that SMEs have little choice but to go to the banks for finance. As the RBA submission points out, SMEs do not have access to well-developed alternatives to bank finance (unlike large business that can access equity markets and corporate bonds - which they did do with great exuberance over the course of the crisis) and hence they have little choice but to approach banks for finance. Further, where alternatives forms of finance to SMEs exist such as private equity, comments from members indicate that such alternatives have become very difficult to access, if at all.

Another possible reason is that the recent investment allowance may have lead to some level of demand for bank finance from SMEs.

One other possible reason why the total value of loans that small business are most likely to take out has **not decreased** (unlike the value of outstanding loans to large business), is SMEs have not had the excess cash to repay debt. During the crisis, large businesses have heavily used the equity markets (which SMEs largely do not have access to) to raise funds, which in large part were used to repay debt.

---

[4] Henry, K '*The Australian Financial System - Emerging from the Global Financial Crisis'* Address to the Count Financial Canberra Conference 15 March 2010
[5] *ibid*

As the RBA points out, the lack of growth in possible lending to the SME sector 'reflects both reduced demand from small businesses and a general tightening in banks' lending standards.'

This experience is not unique to Australia. In March 2009, the Turin Round Table on the Impact of the Global Financial Crisis on SME and Entrepreneurship Financing and Policy Responses found that '… *banks have tightened their lending policies in terms of guarantees, collateral and amounts for all enterprises.*' Also, in a global survey of SMEs, conducted on behalf of a number of accounting bodies including CPA Australia by the Economist Intelligence Unit, just over one-half of those SMEs surveyed saw a deterioration in the availability of finance over the past two years, especially bank lending and private equity funding. Around one-half of respondents also thought the cost of finance had increased.[6]

Members stated that access to bank lending remains difficult, however businesses able to put in the work necessary in preparing their case for finance have a greater chance of getting the finance they need and at terms that are acceptable in the current environment. It must however be noted that a good presentation alone is not sufficient. The business case/presentation needs to be backed up with solid financials and a strong track record.

2.2 Signs of flexibility on behalf of lenders

While lending conditions remain tight, there are signs of lenders becoming more willing to lend as the strength of the recovery grows and the risks of further shocks recede. The RBA made a similar comment in its media release of 2 March 2010:
'*There are some signs that the process of business sector de-leveraging is moderating, with the pace of decline in business credit lessening and indicators that lenders are starting to become more willing to lend to some borrowers …'*

Both the CEOs of Westpac and Commonwealth Bank are expecting an increase in the growth of business credit in the 2011 financial year but also warned that home loan lending growth is likely to slow.[7]

It should be noted that banks are making business decisions on whether to lend to small business and therefore businesses should not construe they have an automatic right of access to finance. Banks should put applicants for finance through a transparent process that avoids unnecessary delays, so that they can make appropriate decisions on providing credit to sustainable and productive businesses. It should be also noted that as banks are in the business of lending, as economic conditions improve we expect to see improved access to finance.

2.3 Costs

According to the RBA, the major banks have increased their Net Interest Margin (NIM), the difference between the bank lending rate and the cash rate, during the crisis in part because of the increase in their bad debts expense and the additional equity they raised in 2009. On the other hand, the regional banks NIM has steadily decreased for much of the crisis, mainly reflecting their larger increases in funding costs and competition from the majors.

The increase in NIM since 2007 has been largest for business and personal loans, in part reflecting a reappraisal of risks on this lending.[8] The sizes of the increases have varied considerably across different loan types. For instance, it is estimated that the variable indicator rate on small business lending has risen by about 200 basis points relative to the cash rate (the average across all classes of loans is estimated to be between 130 to 140 basis points), and many borrowers may have faced increases in their risk margins as well. Such variation in the NIM reflects factors such as changes in the banks perception of riskiness of borrowers, the speed at which loans can be repriced and the sensitivity of borrowers to changes in lending rates.

Having stated this, many members commented that the NIM on some SME finance has increased much higher than the average suggested by the RBA.

---

[6] '*Surviving the drought: Access to finance among small and medium-sized enterprises*' Economist Intelligence Unit October 2009
[7] Smith, M '*Business Credit looking more positive';* and '*Westpac chief confident on corporate lending'* Australian Financial Review 26 March 2010, page 58
[8] Brown *et al 'Recent developments in banks' funding costs and lending rates'* Reserve Bank of Australia Bulletin March 2010

The RBA estimates that the average interest rate increase on large business loans is around 135 basis points relative to the cash rate (there is considerable variation in interest rates across large businesses). The RBA puts this smaller increase down to larger businesses having a bigger share of loans at variable rates and not all outstanding large business loans have yet to be repriced (that is, they are still at pre-crisis levels).

The pressure that bad debts expense was placing on the NIM seems in the words of Deputy Governor Philip Lowe of the RBA to '*to have peaked.*'[9]

In relation to risk premiums, a senior banker was reported in the Australian Financial Review as stating that risk premiums are now starting to come down, however there would be no return to the low margins on offer before the crisis. This senior banker estimated that risk premiums charged to SMEs had risen on average 35 per cent in the past 18 months and he predicts that it will come down by about 10 per cent in the next two to three years.[10]

Given these factors (plus the recent reduction in overall funding costs), it is not surprising that according to some members, the price of finance has recently improved but is still a long way from the prices recorded in mid 2007. With further increases in interest rates forecasted, this will place increasing pressure on the margins of small businesses.

2.4 Information requirements

Members consistently reported to us a substantial increase in the information that banks are requesting and the frequency they require such information. The additional requirements are being imposed on both loan applications and as part of regular reporting to the banks for those with an existing facility. It is understandable that with increases in perceived risk brought on by the crisis, that the banks would seek additional information, however SMEs are struggling with these requests, and in many cases professionals have had to be engaged to prepare such information. Members suggested that banks should provide clients with more notice before making changes to the information they seek. Some members stated that these additional information requirements are not necessarily a bad thing, however banks should have always been asking for such information.

The additional information required is often not produced by SMEs from their systems (because their system can not produce such information and/or they do not produce such information because it is of little use to the business). Members reported that to meet the extra reporting requirements they therefore have had to engage additional resources or transferred staff from other roles and that they would have benefitted from greater notice of such changes. Members questioned the usefulness of such information to the banks and surmised that some of the additional information is only being sort to test whether the business can produce such information.

The Banker/International Federation of Accountants (IFAC) SME Lender Survey of October 2009 found that in the view of bankers, the importance of all information sort by banks from SMEs has increased, indicating a global tightening of lending conditions. In the next 12 to 24 months, bankers responding to the survey indicated that the importance banks place on different information sources would remain higher than was the case pre-GFC, indicating a continuance of tight lending conditions, but with some possible easing.

2.5 Security

Feedback from members and from other sources strongly indicates that banks are lending but that the vast majority of lending is only on a fully collateralised basis. Limiting of unsecured lending can have a significant impact on the working capital of businesses.

However, applicants for loans must realise that security alone is not sufficient. Businesses must primarily be able to demonstrate through forecasts and business plans that they can repay the loan without relying on security.

For those businesses with existing unsecured facilities, it is probable that banks (depending on the facility) have required security as a condition of the continuance of the facility. For those with existing facilities with security, the banks may have re-valued such security and may have asked for additional security, also as a condition of the continuance of such a facility.

[9] Rollins, A '*RBA Flags rates to rise 0.5 per cent*' Australian Financial Review, 26 March 2010, page 4
[10] '*Banks step up competition for loans*' Australian Financial Review 01 February 2010, page 1

CPA Australia also envisages that those people with limited assets and difficulties accessing bank finance for some time to come.

We believe from discussions with members that more personal assets are tied to business lending than previously. If for example, personal assets are being used as security for an overdraft facility or other short-term debt, then this may limit the chance of the business to access other finance as the personal asset is already pledged as security.

2.6 Interest cover

Reflecting the views of members that banks are also requiring higher levels of interest coverage, an article published in the Australian Financial Review, stated that in 2009 '*banks commonly insisted that a customer's annual earnings be equal to at least three times the annual interest they must pay on their loans. For some customers with strong cash flows and balance sheets, this is being reduced to two times.*'[11] During the round tables, members reported banks requiring interest coverage of up to six times. However, it should be noted that the interest cover required varies between industry and risk assessment.

2.7 Loan to valuation ratio

We have received considerable feedback from members that banks have also reduced the loan to valuation ratio that they will accept. This means that there is an increased requirement for equity contributions before a loan application is approved. Although this may not necessarily be detrimental to the business, it will have impacts on SMEs, in particular cash flow and they will also have to factor in that they will have to contribute more of their own money to a project before deciding whether to undertake such a project.

2.8 Changes in demand for credit because of tighter conditions

While many members stated that businesses have been deterred from borrowing due to strict (or perceived strict) lending conditions, there has been no study undertaken (that we are aware of) to verify this. In March 2006, a study of small businesses in Western Australia undertaken on behalf of CPA Australia, found that the most common reasons for not seeking bank finance were:

- the firm had sufficient funds under its existing arrangements
- the firm did not need additional funds.[12]

It would be interesting to test why small business may be demanding less finance since the beginning of the GFC.

3. The importance of reasonable access to funding to support small business expansion and the sector's contribution to employment growth and economic recovery

3.1 Importance of the SME sector

The SME sector makes a significant contribution towards economic growth, national development, innovation and employment. Hence, the growth of the small business sector is fundamental to achieving sustainable economic recovery.

The integral nature of SMEs to the Australian economy is reflected in the following statistics;

- there are approximately 1.93 million active small businesses in Australia
- small businesses make up 96 per cent of all businesses
- small businesses contribute around 35 per cent of Australia's total GDP
- small businesses employ 3.8 million people, accounting for around 46 per cent of total private sector employment, and
- more than 17,000 small businesses are exporters, which in 2008 shipped goods to the value of $1.2 billion in total. [13]

[11] *ibid*
[12] '*The SME 'Finance Gap' Myth or Reality? A research report on SME attitudes and experiences with bank loan applications'* CPA Australia March 2006

3.2 Importance of reasonable access to finance for SMEs in the recovery

Reasonable access to finance will be a key issue for all businesses during the recovery. For SMEs, the issue will be more pressing because of their lack of well-developed alternatives to bank finance apart from the business's or the business owner's own cash.

Business will need to consider the appropriate skills and capacity they will require as the recovery gets underway – importantly this includes how they are going to fund any extra capacity that may be needed. Without such planning, the benefits from the recovery may fail to materialise. While it is understandable that businesses remain conservative in relation to spending money, without such investment, some businesses may find they are under-resourced for the recovery.

The recovery will see many businesses having to increase their stock on hand to meet rising demand, hence their working capital will have to grow to fund such an expansion. With access to unsecure finance (in particular) remaining difficult and very few businesses using alternative sources of finance (such as debtor financing), improving the cash position will be the main avenue for many business to fund the expansion of their working capital. This will require businesses to implement or continue good financial management processes. However, it is important to remember that improved cash management is no panacea. For some business models, external finance is very hard to substitute.

It should be noted that that SMEs have a range of other concerns apart from access to finance. In the latest Sensis Business Index – Small and Medium Enterprises, the primary issues concerning SMEs were lack of work or sales, cash flow, economic climate and finding staff.

Uncertainty about future credit conditions is an obstacle to investment. Lenders and to some extent governments should try to provide more clarity on trends in SME lending and what lenders require from business loan applications.

3.3 Importance of access to finance to employment

In a global survey conducted on behalf of CPA Australia, the Association of Certified Chartered Accountants (UK) and the Certified General Accountants Association of Canada[14] found, not surprisingly that employment by SMEs is sensitive to the supply of finance. The survey found that SMEs facing tough credit conditions and SMEs facing severe cash flow problems are almost three times as likely to lay off staff as those SMEs not so affected.[15]

3.4 Importance of access to finance to facilitate the sale and purchase of business

Some members made the point that some SMEs may, where selling the business is not possible (because potential buyers have difficulty borrowing), simply close their business. This view is shared by David Bird, Chairman of business brokers BizExchange, who was reported to have stated *'A number of brokers have reported that overly restrictive bank lending criteria have prevented some quality businesses changing hands.'*[16]

[13] Prime Minister the Hon Kevin Rudd - speech to the 2009 National Small Business Summit Sebel Hotel - Albert Park – Melbourne June 2009

[14] '*Surviving the drought: Access to finance among small and medium-sized enterprises*' Economist Intelligence Unit October 2009

[15] '*Access to Finance for small and medium sized enterprise sector – evidence and conclusions*' CPA Australia, Certified General Accountants Association of Canada and the Association of Certified Chartered Accountants October 2010, page 10

[16] Fenton-Jones, M '*Crimped by big banks loan criteria*' Australian Financial Review 02 March 2010, page 49

4. The state of competition in small business lending and the impact of the Government's banking guarantees

4.1 Competition

Many members stated that they have seen a reduction in competition between lenders to small business since the beginning of the crisis. The Secretary to the Treasury also observed in a recent speech *'...evidence suggests some diminution of competitive pressures over the past couple of years. Any weakening of competitive pressures would naturally be of concern to policymakers as well as customers.'*[17] However he did go on to say *'And as global financial markets continue to recover, we expect to see competitive pressures in the banking sector rebuild.'*[18]

The effect of this lack of competition (perceived or actual) by members is that many SMEs feel captive to their bank, given the lack of competition within a financial sector dominated by the major banks and to the hassle (actual or perceived) of switching banks.

5. Opportunities and obstacles to other forms of financing, for example equity to support small business start ups, liquidity and growth

5.1 Improving the information and education of SMEs

While the supply of credit to SMEs from banks may have ebbed, we have not seen other providers of finance step into any gaps that may have emerged. For instance, the EIU survey that CPA Australia jointly sponsored, found that (in the view of SMEs) the supply of equity finance, whether from individual investors, institutions or family and friends, is expected to grow at a slower rate than bank lending. For those businesses seeking to diversify their funding sources (to mitigate the risks associated with relying too heavily on one source of finance), this is a potentially negative development.

CPA Australia's 2009 Asia Pacific Small Business Survey shows that Australian small businesses generally use a narrower range of debt financing products in comparison with small businesses in Hong Kong, Malaysia and Singapore[19]. Using such a limited range of products may have contributed to the access to finance problems that small business state they are experiencing.

Our round table discussions highlighted a long standing issue of businesses using the wrong form of finance for what the finance is being used for, for instance using short-term finance for a long-term asset.

Given these above points, we therefore believe there is a role for the governments, lending institutions and professional advisers to improve the capacity for small business to understand what other sources of finance exist, create tools to assist small business choose suitable modes of financing from a larger range of options (including internal sources), and provide tools to assist small business make themselves attractive as recipients of these other forms of financing. Other forms of financing include vendor financing, debtor financing, trade financing, inventory financing and equity financing from individuals and institutions.

We note that the OECD Brasilia Action Statement for SME and Entrepreneurship Financing in March 2006 made a similar recommendation being '…*informing SMEs of the range of financing options (e.g. public guarantee programmes, business angels, and bank loans) will ensure greater take-up of schemes.'*

In this regard, CPA Australia recommends that the government work with lending institutions to develop information and education products that:

- improve small business knowledge of the wide range of financing options that may be available to them
- help small business choose the mode/s of finance that best suit their needs
- assist small business understand what they may need to do to attract finance from a wider range of sources.

---

[17] Henry, K '*The Australian Financial System - Emerging from the Global Financial Crisis'* Address to the Count Financial Canberra Conference 15 March 2010
[18] *ibid*
[19] '*The CPA Australia Asia-Pacific Small Business Survey 2009'* CPA Australia Table 8, page 25

Recommendation:

CPA Australia recommends that the government work with lending institutions to develop information and education products that:

- **improve small business knowledge of the wide range of financing options that may be available to them**
- **help small business choose the mode/s of finance that best suit their needs**
- **assist small business understand what they may need to do to attract finance from a wider range of sources.**

6. Policies, practices and strategies to enhance access to small business finance that exists in other countries

6.1 Policies adopted in other countries

The Turin Round Table issues paper classified the SME policy responses put in place by governments in response to the crisis as follows:

- *Supporting sales and preventing depletion of SMEs working capital.* Policy measures include export credits and insurance, tax reductions and deferrals, better payment discipline by governments and wages subsidies.

- *Enhance SME access to liquidity, mainly to credit.* Measures include bank recapitalisation, expansion or introduction of loan and credit guarantee schemes by governments for SMEs, direct public lending to SMEs, mediating between lenders and borrowers, monitoring and publicly reporting on lending to the sector and establishing a code of conduct for SME lending by banks.

- *Helping SMEs maintain their investment level and more generally their capacity* to respond to the recovery through investment grants and credits, accelerated depreciation, research and development funding and tax incentives.

While the provision of credit guarantees to small business by governments was widely adopted in many countries, the effectiveness of this policy and other policies have yet to be fully evaluated, thus it is difficult to identify best practice. It should also be noted that most of these measures are designed to solve immediate liquidity issues only and have a limited life.

6.2 Code of conduct for lending to SMEs

We note that a number of countries have specific codes of conduct on lending to SMEs, either as voluntary codes, such as in Canada or what appears to be a legislated code in Ireland. In Australia, the Australian Bankers' Association (ABA) has issued a voluntary general code of conduct titled 'Code of Banking Practice'. This Code sets the standards for banks '... *to follow when dealing with persons who are, or who may become our individual and small business customers and their guarantors.'*[20]

We recognise that the ABA has recently reviewed the code; however we believe that there may be an opportunity for the existing code to be adapted to include a section on lending to SMEs or the ABA to issue a supplementary code for lending to SMEs. We see this as an important step in improving the relationship between banks and SMEs.

This benefit is reflected in the European Code of Conduct, which states that the general objective of their code is to contribute '... *to fostering good working relations between credit institutions and SMEs by encouraging a greater mutual understanding of their respective roles and responsibilities.'*[21]

[20] Australian Bankers' Association '*Code of Banking Practice*' clause 1.1

[21] '*Code of Conduct between credit institutions and SMEs*' (Annex to document SEC(2004)484, page 1

During the round tables, many members expressed frustration with their lender/s. The root cause of this was mainly (in the view of members) the lack of communication between banks and SMEs. For instance, members expressed the view that banks unilaterally changed terms and conditions of loan facilities or sort information that had never been previously requested, without adequately communicating this to their SME clients and/or not giving SMEs adequate notice, leaving many SMEs with little time to adapt to the new requirements.

We therefore propose that the ABA consider expanding its existing Code of Banking Practice to encourage better communication between banks and their SME clients (and *vice versa*). To achieve this, the ABA could consider (after wide ranging consultation) adopting all or some of the following elements from the Canadian[22] and Irish[23] codes:

- banks recognise the need for open communications with their SME customers. This entails banks committing to outline joint responsibilities and ensuring all information provided about a credit facility is clear and comprehensible and that key items are brought to the attention of the borrower.
- for those SMEs applying for credit, the banks should make the following information available:
    - directions on how to apply for credit
    - an explanation of the requirements needed to obtain bank credit (such as security, interest coverage, loan to valuation ratios and information and documentation requirements). Where possible, this information should be customised where the bank imposes varying requirements on different businesses
    - an estimate on how long it will take before a credit decision will be made.
- each application for credit by an SME should be judged on its own merits
- when a credit application is approved, the bank should inform the customer about the terms and conditions of financing, including information on default, fee details, charges and interest rates and further information needed by the bank both before and after the loan is granted.
- if credit is declined, the bank should inform the customer about:
    - the main reason(s) for the decision
    - the requirements necessary for the bank to reconsider the application (if applicable)
    - information on alternative sources of financing
- sometimes customers will experience significant change in their business conditions (which occurred for many businesses during the crisis). In these circumstances, banks should carefully review the existing arrangement before deciding what action (if any) should be taken
- if there are changes made to the terms, conditions, fees or lending margins of an existing SME credit facility (whether a general change or a change specific to a client), such as requiring additional information and requiring such information with increased frequency, banks should inform the customer/s as soon as possible. Banks should provide clients with a minimum of 15 days' notice of such changes (unless there are exceptional circumstances).
- having regard to the nature, liquidity and value of collateral, a bank should not impose unreasonable collateral requirements for providing credit facilities, having regard to the value of credit being offered.
- a bank must not impose unreasonable personal guarantee requirements on borrowers
- a bank must promptly, at the request of the borrower, return any security held by the bank, to the borrower when all facilities for which security is pledged, has been repaid.
- a bank must have in place procedures for handling of arrears cases.

[22] '*Voluntary Commitments and Codes of Conduct: Model Code of Conduct for Bank Relations with Small and Medium-Sized Businesses'* Canadian Bankers Association
[23] '*Code of Conduct for Business Lending to Small and Medium Enterprises'* Irish Financial Regulatory Authority, February 2009

- without prejudicing a bank's regulatory and/or legal obligations and legal rights, a bank must:
    - give the borrower reasonable time, having regard to the circumstances of the case, to resolve the arrears case
    - endeavour to agree an approach that will assist the borrower to resolve the arrears problem
    - advise the borrower of any possible impact of the default on the other accounts held by the borrower.
- a bank should explain to borrowers the basis on which interest is calculated. Where a bank charges an interest margin on a credit facility, it must notify affected borrowers promptly of such changes.
- nothing in a code for SME lending should prohibit a bank from acting with all necessary speed to withdraw credit when there is reasonable suspicion of fraud etc

It is important for such a code to note that it should not be construed as a right of access to credit.

Such a code could apply to lending to SMEs in the following credit products:

- overdrafts
- loans
- term loans
- leasing
- hire purchase
- invoice discounting

But excluding:

- lending to other financial institutions
- syndicated or multi-lender loans
- loans to special purpose vehicles

We recognise that the banks may (and should) have to provide additional training to their SME business bankers if such a code is adopted. Such training should include aspects necessary for the successful implementation of the code, especially additional training in finance and accounting and the industries the bankers work in. Even if a code is not adopted, the banks should strongly consider providing such additional training in any case

In this regard, CPA Australia recommends that the ABA consider amending its existing Code of Banking Practice to include a section on bank lending to SMEs. We suggest that the ABA consider reviewing the Canadian and Irish codes of conduct on lending to SMEs as part of such a process.

Recommendation:

We recommend that the ABA consider amending its existing Code of Banking Practice to include a section on bank lending to SMEs. We suggest that the ABA consider reviewing the Canadian and Irish codes of conduct on lending to SMEs as part of such a process.

6.3 Data on bank lending

The governments or their agencies of a number of major economies (including US, UK and Canada) produce a regular Bank Lending Survey, which measures changes in demand for finance by SMEs as perceived by bank officials. The Turin Round table issues paper suggest that such a survey methodology could be best practice, especially if it included all other forms of financing available to SMEs. It should be noted that in Australia, there are a number of private surveys seeking to measure changes in demand for finance as perceived by SMEs.

In this regard, CPA Australia recommends that the government or its agencies, investigate whether introducing a Bank Lending Survey measuring changes in demand for debt finance by SMEs as perceived by senior bankers will help the business community understand trends in business lending.

Recommendation:

The government or its agencies, investigate whether introducing a Bank Lending Survey measuring changes in demand for debt finance by SMEs as perceived by senior bankers will help the business community understand trends in business lending.

7. Any other relevant matters

7.1 Attracting finance

With access to finance likely to remain a challenge for many businesses, it remains very important for businesses seeking external finance to prepare a compelling business case for potential lenders/investors and to understand that lenders now expect greater documentary evidence of capacity to repay. Hence seeking finance is not an easy task (and nor should it be), and SMEs should consider engaging professionals to assist them or develop the skills to improve the financial literacy.

7.2 Improving financial management

It is clear from CPA Australia's Asia Pacific Small Business survey[24] that in 2009, more Australian small businesses believe that obtaining finance over the coming 12 months would be difficult to very difficult than was the case in 2008. Accordingly small businesses in Australia would benefit from improving how they manage their businesses (as they may not have access to external finance to tide things over), particularly how they manage their finances.

Such improvements can enhance the prospects of obtaining external finance, developing internal supply of cash of finance (so that external sources of finance may not be needed) and improving how they manage their business. We therefore believe that there is further scope for the government to support small business through subsidised training and information and education products on financial management.

We note that the issues paper to the *Turin Round Table on the Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses* made a similar preliminary recommendation, being:

> *'In times of crisis, the managerial competencies of SMEs, - especially in the field of finance – have to be supported. In order to improve financial knowledge of SMEs, Governments could support, in the short-term, business development services and training programmes.'*

In this regard, CPA Australia recommends that the government provides further support to small business through subsidised training and information and education products that help to develop the financial management skills.

Recommendation:

CPA Australia recommends that the government provides further support to small business through subsidised training and information and education products that help to develop the financial management skills.

7.3 Additional training for business bankers

While appreciating the extra resources banks are putting in via business bankers, members believed that such moves have yet to achieve improved relationships, and in some cases have been counterproductive to relationships because of the poor experience (in the eyes of members) of some business bankers. This may be because of differing expectations between the banks and their clients as to the role of business bankers.

[24] '*CPA Australia, The Asia Pacific Small Business Survey*' September 2009

Given this, we believe that the banks and other business lenders should consider providing additional technical training to their business banking staff so that such staff have a very good understanding of financial matters and the industries in which their clients work in

Such comments are supported in a report from East and Partners, which states:
'An increasing problem for the banking sector is that the introduction of relationship managers for SMEs is not having the positive effect expected because those managers are tending to move around to quickly.'[25]

7.4 Expected supply of finance

The Banker/IFAC SME Lender Survey of October 2009 (a global survey) found the following when asking bankers what actions they anticipate their bank taking with respect of SME lending in the next 12 to 24 months:

- increasing the number of loans approved for new clients 36%
- increasing loan amounts to new clients 32.4%
- tightening loan criteria 16.2%
- loosening loan criteria 7.5%
- further restricting loan amounts 4.2%
- further restricting the number of new loans issued 3.6%

While this is a global survey and the impact of the crisis on different banking systems and the pace of recovery between different countries is different, the results show a general move towards greater flexibility and willingness to lend (which does not necessarily mean an easing in credit conditions).

While people such as the Secretary of the Treasury believe that we will not see a return to the credit conditions that prevailed prior to the crisis, over one-half of respondents to a global SME survey that CPA Australia co-sponsored expect to see a broad return to pre-crisis levels of availability of finance by 2011 or before.[26]

7.5 Response of large business to tighter credit conditions

Large businesses, particularly the ASX 100 responded to the tightening of lending conditions by seeking finance from alternative sources. In particular, they turned to the equity markets, raising $98.6 billion in 2009 through secondary raisings (the largest amount ever raised on the ASX through secondary raisings). The largest companies also used the corporate bond market to raise funding on terms and conditions they were more comfortable with.

Much of this funding was used to pay down corporate debt, which helped to bring down interest expenses paid by the ASX 100 by more than 30 per cent, according to Goldman Sachs JB Were.[27] Having stated that, a recent survey of Chief Financial Officers of ASX 300 companies by Deloitte found that the focus is shifting from repairing the balance sheet (e.g. debt reduction) to growth. Almost 40 per cent of respondents to the survey indicated they intend to increase their borrowings this year.[28] This however indicates that a majority of large businesses are still hoarding cash (according to a report by JB Were Goldman Sachs, the ASX 100 has around $65 billion in cash sitting on their balance sheets, almost double the figure at the start of 2009[29]) as a safety buffer in case the recovery is not sustainable and/or as a source of finance for possible mergers and acquisitions.

Large business have also taken a more prudent response to their funding sources by reducing their reliance on bank debt, improving their cash position and increasing funding from secondary raisings (equity finance) on the ASX and corporate bonds.

7.6 Opportunities

Businesses that are in a strong financial position should consider opportunities to expand by acquiring competitors, making capital investments and opening in new markets.

---

[25] Clout, J '*Level of discontent with banks rising'* Australian Financial Review 16 March 2010, page 52
[26] '*Surviving the drought: Access to finance among small and medium-sized enterprises'* Economist Intelligence Unit October 2009
[27] Liondis, G '*The joys of debt repayment'* Australian Financial Review 3 March 2010, page 25
[28] Rollins, A '*Focus turns to expansion in recovery'* Australian Financial Review 16 February 2010, page 8
[29] Liondis, G *'Cash returns on the horizon'* Australian Financial Review 17 March 2010, page 19

8. Conclusions

Overall, it must be stressed that banks are important part, but are only one part of any solutions to improving access of economically viable small business to finance. SMEs also have to do their part to improve transparency of their economic and financial conditions as well as improving the quality of their credit control. Advisers (and to some extent governments) also have an important role in communicating this to SMEs and helping them achieve this.

Attachment

Small Business Access to Finance: A detailed summary of member views

1. Background

In March 2010, CPA Australia organised four round tables on small to medium-sized enterprises (SME) access to finance. The round table were held in Canberra, Melbourne, Brisbane and Sydney and involved some 60 members who work for or advise SMEs, and who have had recent experience seeking finance for their employer/client.

The below seeks to represent the views of the CPA Australia members who participated in the round table discussions on the access of small business to finance. CPA Australia does not vouch for the accuracy of these views, nor do these views necessarily represent the views of CPA Australia.

All possible care has been taken to accurately represent the views of members expressed in the round table.

Accessing finance is a critical issue for many small and medium-sized enterprises (SMEs). CPAs, as strategic business leaders and finance experts, play a critical role in advising on and assisting business access finance. Our members therefore have a unique and interesting perspective on the issues surrounding access to finance, therefore this document attempts to capture these views for the benefit of the broader community.

We would like to acknowledge the facilitator of these round tables, Jan Barned CPA, who has worked in the finance industry over the past 20 years and the contribution of members who participated in CPA Australia's access to finance round tables in Brisbane (the CPA Australia Queensland Division SME Committee), Canberra (the CPA Australia ACT Division SME Committee), Melbourne (the CPA Australia Victorian Division SME Committee) and Sydney (the CPA Australia New South Wales SME Discussion Group). We would also like to thank those members who contributed their views and experiences through other mediums.

2. Introduction

In March 2010, CPA Australia conducted a series of facilitated roundtable discussions with members working within the SME sector to gather their own or their clients' recent experiences with raising finance for their business. These sessions were held in Melbourne, Canberra, Brisbane and Sydney.
The outcomes of these facilitated discussions are outlined below.

Generally, the findings from the discussion all concluded that the pendulum had swung from pre GFC environment of lenders being often too generous on lending conditions to the banks being so risk adverse that many SMEs are finding it difficult to raise external finance. Members reported that businesses have struggled with the tightening of lending conditions, not only because it affected their ability to raise finance but also because they reported inadequate notice to amend their business practices and systems to meet the new conditions.

As a member stated at the Brisbane roundtable 'I think the biggest problem was that the banks were adamant that there were funds available. Yes the funds were available however they lifted the bar so significantly after the crunch came that it made it almost impossible for some successful small businesses to apply for funds. Prior to December 2008, the availability of funds was fairly easy. You basically went in with standard business plan, couple year's financials and they would approve it there and then. What they then wanted after December 2008 was very detailed financial statements, very detailed cash flow statements, and very detailed breakdown and analysis of financial records; information they had never asked for before.'

The main theme to come out of the round tables was the damage done to the relationship between banks and SMEs over the course of the crisis. While members generally understood the need for banks to take a more prudent approach to lending in the current economic environment, such as requiring greater level of security and more information, members expressed the view that banks needed to improve their transparency and communication on their tighter conditions to business, including providing more notice on such changes.

The roundtable discussions also highlighted a number of other issues that were found to be impacting both potential and existing financing arrangements for SMEs over the past year. These were:

- Banks were still lending however finance is essentially only available where the loan is fully secured by quality assets and personal guarantees
- Increased compliance/information requirements
- The lack of experience of bankers, the high turnover of business bankers and their lack of authority
- Lack of competition
- The economic impacts on small and medium sized businesses

What is interesting to note is that all of these key themes were issues discussed at the roundtable conducted by Minister Emerson on the same topic in March 2009. Given this, some members expressed the view that the banks have done very little to assist in supporting SMEs to access finance during the past year.

3. Increased security/collateral requirements

It is evident from all four discussion groups that the banks are requesting increased security for both new and existing loans. From the inception of the global financial crisis, the banks were acutely aware that the fallout from this event would change the risk profile of most businesses. The first step that they undertook was to review their loan portfolios with additional rigour. The result was many businesses were required to agree to changed loan conditions that included either security that had not been required in the past or an increase in the level of security that supported the loan. For most new financings, security was now essential. As a member who owns a small business based in Cairns confirms 'If you are looking at start ups, if these businesses do not have solid equity in their own homes, which is what the bank wants as security, then the banks will not even consider them.'

With their new risk adverse demeanour, that bank's are also scrutinising the types of security that they were prepared to accept. In days gone past, many established businesses were able to borrow from the assets on the balance sheet. Now the banks are looking at the quality of these assets. In particular, intangibles such as goodwill, cash flow and profitability no longer cut the grade as a quality asset. As a Canberra-based public practitioner stated that one of his customers was 'Wanting to purchase another business that had $100,000 goodwill and the bank said 'No way' but when he went to borrow $100,000 for a car, he walked into the bank and within fifteen minutes walked out with the loan for the car. The banks are looking for tangible security and goodwill does not offer that. The banks cannot quantify goodwill and are concerned that the goodwill will walk with the previous owner.' What makes the current situation even more difficult is that many assets have also suffered from a decrease in value during the GFC. When the banks undertake their annual review, they are now dissecting the balance sheet in more detail than ever before and many businesses are finding that the banks were questioning the implied value of the assets used as security and assigning lesser values.

This approach to asset revaluations has been exacerbated by the suggestions that the banks have decreased the loan to value ratios (LVR) as a response to managing the risk profile of their customers. In many cases the consequences of such action is that the banks are now asking for more security. Such requests may be indirectly affecting cash flow as a member in Brisbane points out: 'small businesses are required to use personal assets to secure loans, such as the family home. With the decreasing value of some of these assets, the banks are now saying that the business has to reduce the level of debt to met decreasing LVR and asset valuations and this is having a major impact on cash flows of small business.' (as they will probably have to use cash to repay debt rather than use it in the business).

Many of the attendees at the roundtables discussions also mentioned that there has been a demise of cash flow and profit lending. The Canberra-based public practitioner stated 'The banks are less willing to lend for future expansion for business where the serviceability of the loan will be tied to future profitability, even where the owner is a very experienced business operator' and a Queensland member goes out on a limb by stating 'Any bank that is telling you that they will do cash flow lending is lying.' They are lending against tangibles that they have a legal right over – the intangibles that they previously used as security has now stopped.' Simply put, the banks want solid security that will provide a 'real' cover for any loan default.

The same member believes ‘The current practice of the banks is that they have gone too far. They are only looking for security – if you are a property borrower they are doing 50% LVR, if you are lucky. If you have any other type of business, they will only lend on 80% of your debtors.’

However, as the Canberra-based public practitioner notes, the requests from the banks for additional security can also provide the business with funding that is better suited to the purpose, as was the case for one of his clients: ‘The client wanted to extend their current overdraft facility from $250,000 to $ 650,000 to cover the $450,000 for fit out of the two shops [the lease on the shops require a fit out every five years, so the effective life of the fit out is five years]. Last week the bank came back and said that they were withdrawing the overdraft and that the owner now had to take out a lease facility or some other loan facility to cover the $450,000 over a two, three or four year period. The client wanted to keep the full $650,000 facility overdraft, but the bank was only prepared to allow the original $250,000 overdraft. The terms and conditions offered by the bank are very fair and reasonable. I think this is a good thing [as the loan better matched the purpose for which the funds were to be used for], but it is not what the customer wanted.’

The roundtable discussions uncovered that in addition to tangible security, the banks are also asking for personal and directors guarantees. Although this is not something totally new, a surprise finding was that a number of the members had also been asked to provide key man insurance. One member shared that ‘We did have to try and restructure some of our debt and with that came the personal guarantees from all the directors that had not been in place previously. They were asking for more security and they even asked for key man insurance.’ This is insurance covers the key personnel in the business and provides the banks with some certainty that the business will continue to operate under the current management. This type of insurance is quite expensive and of course the cost is borne by the business not the bank.

The upshot of these additional security requirements in many cases is that the businesses are now handing over all of the available security to their bank, which in turn will limits their ability to switch banks. When this point was raised, the Canberra-based public practitioner agreed and even questioned the impact on the SMEs ability to seek competitive finance ‘That’s exactly right – you cannot go elsewhere because you do not have security to offer and this [inability to switch] removes the negotiating power.’ The other area associated with the banks securing all of the assets as security, is that this can increase the SME’s risk. The inability to diversify their banking facilities (because all the security is held by the existing bank) may have dire consequences in the shifting appetite of the banks. One CPA confirmed that there is risk in banking with only one bank ‘What happened was the bank just fundamentally changed its’ mind – it said, I don’t want to bank you anymore.’

4. Substantial increase in compliance

The overwhelming response from all of our discussions was that the banks are asking for additional information from business. Obviously with an increase in the perceived risk, the banks are supplementing the level of security with more detailed financial information from the business. Members also reported that the regular reviews that banks undertake of loan facilities are at a more detailed level than ever before, with not only past financial statements being requested, but budgets and forecasts, in particular cash flow forecasts. The banks are in the business of lending and are looking at the ability of the business to service the loans, particularly under this new regime created by the global financial crisis.

The Chair of the Victorian SME Committee confirms this (when speaking about her employer): ‘There is no question about the debt coverage because our financials are very strong. The issues are around the fact we have moved to a new risk assessment and all our loan compliance is sent to Head office and they are sending down more detailed requests for more information.’ A Queensland member agrees ‘They said that the risk profile had changed, and therefore they had to be more discerning in how they evaluated applications for credit. In our own business, they started asking for information that they had never asked for before. They were always given an abridged version, however now they wanted much more detail.’ The Chair of the Victorian SME Committee also mentioned that her banks had asked for access to the business’s ATO portal, a request that a number of the participants at the roundtables had also experienced.

What poses as a potential trap for SMEs is the fact that pre GFC banks were not necessarily enforcing compliance requirements and this has created a dangerous environment for businesses that may not be aware of their obligations. The Chair of the Queensland SME Committee makes the observation ‘Often it is only when business is faced with risk of insolvency, that they find out what is in their covenants and this is when their banker finds out too, because it is actually only credit department back in the bank that understands this stuff. This department changes the rules and the manager then has to come and tell you that all is changed.’ However in response, another Queensland member pointed out ‘They don’t change the rules, they apply them. Most SMEs don’t understand that really their loans are at call at anytime and it does not have to be a practical default, it can be a technical default and the banks are really good at issuing letters of non waiver – in other words, we will let you run on until we are ready to pull the rug. So the real issue that goes back right to the beginning is ‘What are you signing up for’ which is the old Caveat Emptor – let the buyer beware.’ This view may well be confirmed by one members own experience ‘We did have quarterly reporting and we had to meet certain covenants. They had, up to that point, given us a lot of flexibility. Then it became black and white. There was the threat of breach notices if it went beyond what we should have been going beyond.’

In addition to enhanced reporting requirements, there was agreement among the members that the banks are now requiring additional information that is outside of the current loan agreements or covenants. With both the level of information and frequency of the provision of this information on the increase, one member suggested that the banks are in fact testing the real need for funding ‘I think they are trying to create a workload for small business that was beyond their means and then was pushing them to the bounds of whether they really wanted the finance or not.’ With the GFC creating new challenges to SMEs, those who have obligations to banks have been really starting to feel the extra burden that comes with meeting bank requirements.

As resources start to be stretched to the limit, preparing additional information to support loans members hold the view that these requests are beginning to impact on the overall operations of the business and in many cases increase the costs. The member who owns a small business in Cairns comments: ‘Many businesses have had to let go staff which means that the business owners are now back in their business working. This means that they do not have the resources or the time to prepare the extra information if they don’t automatically do it anyway.’

Another Queensland member also points to the direct cost factor under these conditions: ‘The [extra reporting requirements] has put an extra burden on a lot of small businesses that were not (appropriately) geared up to provide (the banks with) these extra requests. In my experience, they then had to seek requests from practitioners to prepare the extra information to send into the bank, which then cost them.’ A public practitioner from Melbourne confirmed these additional costs have the real potential to impact cash flow: ‘My experience is that SMEs with turnover in the $10 to $20 million range, if they were established businesses with established relationships and existing facilities in place, survived quite nicely. However at a time when they had cash flow issues and needed more funds, then the banks would put pressure on them for more security, stricter covenants, increase in reporting requirements including audit obligations that the customer had to meet. The banks have often appointed one of the big four accounting firms to undertake an audit at a cost of $10,000 to $30,000 a quarter to the customer.’

What was very interesting during our discussions was the number of members that actually questioned the usefulness to the banks of this additional information that is being requested. A member working for a Queensland-based mining company comments ‘They don’t seem to understand what is in the forecast, because they keep asking questions – they just don’t seem to get it. I don’t think they know what they are looking at, especially for a mining company, unless they have a background in mining. We have been trying a new business model and parts of this are untested, so even the management cannot guarantee the outcomes.’ And the chair of the Queensland SME committee agrees: ‘I would say it’s not just extra requirements, but the very fact that no one knew what was going to happen six months time, yet someone at the bank said you have to forecast it and tell them what you thought on what your earnings were going to be. How can they do this when no one knows – the banks did not know - Ben Bernanke has not got a clue - so how do they think that the business owners will know? But still they ask nonetheless.’

Another member from Brisbane asked the poignant question ‘Do the banks measure the forecasts to actual results?’ and the answer was ‘No’ however another member did clarify the use of such additional information in his view ‘The moment you have an investigating accountant assigned to your business is the day that you will find your forecasts pulled apart. Not last month or the month before, but going back twelve months. They will actually engage external accountants to ask the questions about what is going on. So, there is a very fine line to what I would call the ‘rope’ to which you can continue to lead yourself out and then there’s the time when the rope gets yanked, and then it’s a very painful experience for those involved.’

We did ask the round tables if SMEs should be preparing this type of information to support business practices, and a number of members were quick to reply that due to the size of SMEs, in most cases owners and operators have a good handle on where the business is at, even without this level of detail. One member provides an interesting take on this topic 'I have not met a small business owner yet that does not know more than the accountant. They have the answer before you even show them the numbers.' Another member states 'I believe that this is where the psyche of big business differs from small business. Small business is much more attuned to who their customers are and how they operate than big business. Big business is normally one, two or three times removed from the client.'

The same member also believes it is not just the numbers that the banks are struggling to understand: 'I think it goes further than what [the members] are saying, not only do they [the business banker] not understand the numbers, they don't understand the nature of the business. They may see a hairdresser this morning, a cafe at lunchtime, a retailer in the afternoon and they cannot get their mind across the variety of industries that small business is in and I think that this then raises the risk profile across the board for all SMEs.'

Most of the members attending the round tables did have a view on the increase reporting requirements and not all was negative. 'In some sense I don't think that the bank asking for extra information is necessarily a bad thing' is the view of one member which another member supports when he stated 'I think the banks are now doing what perhaps they should have always been doing. They are now reviewing the information that you have been casually giving them over the past few years, you cannot begrudge them that.'

Perhaps the following observation from one member may provide insight into the rationale for increased reporting: 'The banks are asking for more detail than before on regular reporting – I believe that this is a way of gauging how confident you are. So they ask a question and if you tend to load them with almost too much information, they back off. It comes to a point where they don't understand the business, and so they have to have confidence in the people – I think at the end of the day that's a lot of it – they have to have confidence in you and you have to tick all the boxes.' Perhaps this is why we are seeing an increase in the requests for key man insurance?

5. Bank staff experience, turnover and authority

During the discussions on increase compliance requirements, members consistently commented on the lack of experience of business bankers. A representative of one of the major banks at the Minister's round table in March 2009 provided one reason for this when he commented that due to staff turnover at the bank, many of their bank managers have less than three years relevant experience. Members' experiences over the last twelve to eighteen months indicates that there may well be the demise in the traditional banking relationship between the bank manager and the customer. With the higher level of reporting and more rigorous reviews, coupled with a perceived shift in risk profile and inexperienced bank managers, bank credit teams are playing a larger role than ever before in loan evaluations, both new and existing.

One Canberra-based member notes the importance of the traditional banking relationship and the changing landscape: 'What used to happen, was you would walk into the bank and you would shake the bank manager's hand – you knew the bank manager for the last six month, years whatever. Now when I walk into the bank, there is no one there. They don't know you.'

But just how important is the lack of a long standing relationship between a bank manager and a business? As the same member went on to state 'In the past the bank manager would go out on the line [to the bank's credit department] and say 'These are good customers' and you would go and talk to the bank manager and you could get a loan on your creditability, but now, it appears that bank managers do not have the expertise to assess business loans appropriately, no matter how experienced.' One member even went so far as to comment 'They deliberately put managers in branches that have either no authority or no expertise so they simply cannot approve a loan. I think that's a policy.'

The level of experience of the bank managers has, in many cases, led SMEs to dedicate additional resources to educate them on how the business operates: 'The experience of the banker in my previous employment was very good. He would come out and I would present him with a pack and we would discuss it together. He was then redeployed and we started to get new relationship managers through. I had to explain the numbers; they did not understand the business as well. So at the time when you are asking for additional funding and you have to explain the business as well to people that are not familiar with it, there was that double frustration. They were inexperienced in reviewing the financials from a credit risk perspective.' one member confirms.

The other issue that surfaced when discussing bankers experience was the authorisation policy. In particular, during the discussions in Brisbane, where two of our members came from regional areas, it was noted that regional managers are referring business back to capital cities, which in some instances could impact on the how the business manages the relationship. A Rockhampton-based member notes that for their business 'Our banking is all done in Brisbane, not in Rockhampton. Our CFO is based in Brisbane and his job for the last six months has been to talk to the banks constantly.' Although some would argue that this should be one of the roles of the CFO [Chief Financial Officer], it appears that the banking relationship has shifted gear since the beginning of the GFC and can be, in some instances, very demanding on the resources of the business.

Our members in Canberra have had similar experiences. One Canberra-based member states 'Part of the issue with the banks in Canberra is that everything is referred to either Sydney or Melbourne and this is most likely the issue with most regional centres' and another Canberra-based member pointed out that this then can threaten the loan application process 'You are hard pressed to find business managers, or account managers [with a bank] that have the background and skills to argue the toss with head offices.' The real issue for these regional centres is that when a portfolio is referred, then the likelihood that each individual business will be assessed on the merits of the business is reduced. As the Canberra member says 'It then becomes a real issue of 'tick the box'.'

Interestingly, at the Minister's roundtable in March 2009, the banks were adamant that the demand for finance had decreased. At the time, the representatives from the industry bodies argued that this was, in part, due to the 'tick the box' mentality that had surfaced in the face of managing changing risk assessments and that demand had not changed, it was simply the fact that most applications were not meeting the standards set by the credit departments and therefore, the applications were never processed. When we raised these differing views with the members, the response was that both were correct. As one member stated 'I would say that both demand has dropped and also the compliance issues have come into play. Some tasks that were marginal when the boom times were on just are not possible now under the current economic conditions, the price isn't there in the market.' One member from a large business who attended the Brisbane round table stated and other members agreed that business is just disinterested in going to the banks because it is too much hassle and too much expense to have all the information prepared. With manager's time poor, it is easier to finance the business internally. These businesses have not even bothered to go to the banks.

What becomes critical under current circumstances is how the information is prepared and presented to the bank. A Sydney public practitioner believes this is a particular issue for micro businesses 'They don't even know how to approach the bank in the first place. There is no assistance out there to tell them what they will need - for example, three year financials, three years of tax returns, a business plan etc. They don't know how to do it and currently they are too busy trying to survive on a day to day basis to be able to do it.' A Canberra public practitioner does provide some practical advice 'Presentation is everything. You have to have cash flow forecasts, figures, everything that is in a good light – the more paperwork the better. They even want to see photos – really the best presentation they can get. If you are lacking on anything to do with figures or forecasts, you have no chance. Even though they are taking on larger portion of security, they still want to see forecasts because they would much rather see you pay back the loan than foreclose and then they will keep you as a client.'

It therefore appears that the lack of experience by many banker managers and the elevated level of information that is required is placing additional strain on SMEs to service the needs of the banks and ensure that they can continue to access appropriate finance during this time.

6. Lack of competition

One of the first responses to the global financial crisis was that some foreign banks pulled out or reduced their exposure to offshore lending in a bid to ensure adequate finance was available to their domestic customers. Australia was not immune to this move and the presence of foreign banks has reduced. This coupled with the mergers of a number of second tier banks with major banks has resulted in a reduced range of possible lenders.

One member stated that 'The government has failed by allowing the big four to take over the smaller banks like BankWest and St George. What they should have done is follow the example set by the UK and taken these banks over and kept them until some improvement. This would have kept the competition in the market. There is definitely a lack of competition.' The Chair of the Victorian SME Committee agrees 'When we were getting competitive quotes for funding for an investment, we found that there would be two banks close together, and another two further apart, but the gap between the two groups was substantial. The goal posts have shifted and what tells me is that there is less competition out there.'

Some members stated that the root cause of the issues discussed in this paper is the lack of competition. This has resulted in a shift of power to the banks that is impacting on SMEs ability to negotiate competitive deals. As a Sydney-based member states, 'A lack of competition is still going to be a problem. Now with a number of the second tier banks gone, the major four will just sit back and dictate what they want. I think that there needs to be viable alternative sources because then the big four will actually have to work for their market share.'

It appears that the lack of competition has also impacted the role of the finance broker. With resources dedicated to the increase in compliance and other bank requirements, coupled with the limited ability of some SMEs to appropriately assess finance alternatives, a number of members believe the role of the finance broker has been critical to these businesses. However, the loss of a number of second tier financiers has resulted in limiting the offer that the finance brokers have available, as a member who attended the Canberra roundtable observed 'They do not have the variety on offer to give alternatives and due to lack of competition, the offers are not as good as they used to be. Also, these brokers are at the end of the chain, so when they are applying on behalf of a customer, their application is, in some instances taking up to six to eight weeks to assess when previously it would have taken two weeks. Many small business owners rely on brokers, as they are doing everything for their business and therefore it is beneficial for them to use brokers.' This then raises the question as to whether SMEs have the ability, given these circumstances, to optimise their financing arrangements.

With the role of the finance broker limited and the lack of viable second tier financiers, the ability for business to switch financiers comes into question. Asa prominent Queensland member points out 'The government was well intended when it said a few years ago that it would make switching banks easier. However no one took account of the huge opportunity cost, particularly the government when the small business has to go and start looking around to get another finance facility. It's not only the business finance, but also the personal, all the ancillary finance and hire purchase etc., that needs to be changed and they just don't have the time, particularly now when the business owners have been required to work back in the business and have the extra burden of the additional information required by the banks. In addition, with small businesses required to use personal assets to secure loans, switching carries large costs.' Another member agrees 'This is good point on costs. There is a large cost associated with transferring banking – stamp duty in particular. So, the business owners then say, why should I spend $ 100,000 to transfer my banking across?' Therefore, potentially, the banks have certain leeway to leverage up their requirements on businesses in the form of fees, information, security and any other compliance requirements, which could be difficult to work around in a cost effective manner due to the lack of competition and costs associated with switching financiers.'

7. Economic Impact

The new tighter credit conditions have created many flow-on effects for SMEs. From our discussions with members, it becomes apparent that businesses are being faced with a number of different challenges during this time of transformation.

Until recently, Australia had been in one of the lowest interest rate environments in history. One of the more surprising outcomes from the roundtable discussions was that during this low interest rate period, most members saw an increase in cost of funds for business. The Chair of the Victorian SME Committee stated 'It is more expensive to borrow in the low interest rate environment, than it was two years ago when rates were higher. The margins are higher, the fees have increased, even with more reporting and increased security' Another member went so far as to say that the banks had taken advantage of the situation and repriced risk that had previously been underpriced.

The banks may argue (reasonably) that this was due to the change in risk profile brought about from the GFC, however one member had a differing view to this point, claiming that the tight credit conditions allowed the banks to re-evaluate lending criteria, which in some instances highlighted that fact that they had lent to SMEs that never should have had finance in the first place. A Victorian public practitioner believes that the banks simply used situation to improve their positions 'I think that this has been a good opportunity for the banks to restructure loans, and if they had any gaps in terms of their security requirements, to make sure they tightened all those up. So I think that in the end it gave them an opportunity to clean their act up at a time when the customer was at their mercy, and would sign just about anything, especially if they needed any increase in facilities or additional funding.'

Whatever the reasons for increases in cost of funding, one of the more important outcomes from the increase in costs is the impact on cash flow. Feedback from our members suggests that with many SMEs already struggling from a reduce level of demand and tight cash flow, in an environment where finance has been difficult to access and/or service, their focus has shifted to assess alternative ways to finance their needs.

This is a direct result of the current credit market conditions.   As the Chair of the Queensland SME Committee concedes ‘We are talking about access and access is not just the banks having money. The reality is if you put up the price of the drawdown, make it half a percent, if you put up the registration fee, if you put up the other charges for investigating and evaluating the business, if you have more in holding fees then that puts up the cost of finance. They have ratcheted up the physical margin of the loans, and they have gone security heavy, so now people just look at this picture and say equity is cheaper. It’s cheaper to put my own money in, ask shareholders or frankly, just don’t bother with the growth. So that’s what has happened.’

Another member confirms that their bank have ratcheted up the equity requirement post GFC ‘Subsequent to the GFC [although the facilities had been approved pre GFC], they are now requesting that we fund some of the construction from equity, despite the fact that they would have security threefold of the value of the construction value.’

A Queensland member provides insight into how increases in equity requirements are becoming common place to manufacturers out of necessity: ‘If you are a manufacturer in this country and rely on work in progress (WIP), there is no one in this country that is financing WIP. So these businesses are faced with the task of building up equity to fund WIP and then hopefully finance under factoring for 30 days – most WIP is 90 days plus.’

Various members confirmed the view that tighter credit conditions are impacting the working capital of many SMEs. It was suggested that in some instances, the banks were actually dictating what terms and conditions the business is to impose on their suppliers. The Chair of the Queensland SME Committee states: ‘We saw a $15 million increase in working capital needs in four months because between insurance companies and the banks they tightened all of our supplier’s terms and therefore our creditors days went from 47 to 28. They said if you don’t do it then we won’t supply, it’s as simple as that.’ The member at the same round table adds: ‘and our debtors days went from 47 to 62’ Such dramatic shift in operational trading terms, at a time when many were unable to find finance, can only exacerbate cash flow issues, particularly with SMEs who are often undercapitalised anyway.

However not all the conversations were ‘doom and gloom’. A interesting perspective was provided by a representative of a large logistics/transport company. He shared with the Brisbane round table how his employer was supporting customers who have cash flow issues: ‘What I have seen is twofold, businesses struggling for working capital [even though they were highly capitalised] and businesses struggling for growth or tangible capital. I worked with our customers more to fund working capital, through the provision of more generous credit terms or extension of credit limits.’

The member went on to say ‘We had a lot of customers come back to us and say that they were cutting costs. I think some businesses have been a bit slower in this area and are only just now getting around to it. A couple things happened. A couple of customers came to us seeking help to shorten lead times in transit. Transit time is a big player in inventories. So, by shortening their lead times and shorten their transit times they were able to decrease their inventories and reduce their warehouse costs - that was mostly the east coast customers.

The east to west coast customers actually extended their lead times. They reduced their warehousing capacity by extending lead times through the utilisation of slower modes – the result was for most they gained two weeks free warehousing. So they could put half their warehouse into containers and instead of putting it on a train [which takes about two weeks], they put it on a boat to Perth, which takes about four weeks to Perth. The other thing we did was offer free warehousing at both ends and that was our way of increasing market share, as the smaller transport companies did not have the capacity to do so. This enabled them to either do away completely with the third party warehousing provider, or downsize their own in-house warehouse.   In summary, we assisted our customers cutting costs, providing warehousing, inventory management and providing improved working capital (and hence cash flow) through increased credit limits and extended credit terms.’

A member working for a mining business also shared how his employer had used alternative financing arrangements to assist with working capital requirements ‘Another thing that we have done has accessed trade finance for our exports – as soon as the stock is on the water, then we receive the funds from the bank. The goods could be on the water for six weeks and then with the customer for another 60 days and then they pay us. This has helped cash flow quite a bit.’

In Sydney, a senior member suggested that SMEs should look towards alternative forms of finance to substitute bank funds that now carry heavy compliance burden and higher cost. The member spoke about funding the business from the debtor book. He believes that this is a viable method of finance, particularly where a SMEs has quality customers on their books. Although the member conceded that most financiers will only finance to a possible maximum of 80% of the value of the debtor book and that this type of finance usually does not come cheap, he made a valid point that for those SMEs who were looking for new facilities, then the barriers to entry on these types of loans are likely to be a lot lower than the financing requirements the banks are demanding.

One Canberra-based member showed real concern for the flow on effects from the tight lending conditions of the banks. In particular, he explained the impact on business as a result of banks now only lending on tangible security: 'I have had three clients in the last twelve months that have attempted to purchase new businesses, all experienced business owners and they have had to pull out of the purchase as they could not access finance through the banks. The banks cannot quantify goodwill and are concerned that the goodwill will walk with the previous owner.' He then reflects on possible further impacts to business 'This then causes older entrepreneurs looking to retire with successful businesses, issues as the banks will not lend against goodwill and therefore they cannot sell their business. How are they going to sell the business?' A Sydney member elaborated on the possible macroeconomic issue this may cause 'The fact that SMEs are big employers and if they cannot sell their business they may just have to close their business down, then that's jobs lost.'

Members agreed that most in this sector were not in a position to move forward with growth. The reasons given varied, however all agreed that the common issue was the uncertainty of the economic environment and the limited ability to access finance to support expansion. One Victorian member confirms 'Our customers were not in growth mode. If they had plans to grow or invest they stopped. There were very few transactions in the market - people did not want to buy at even bargain prices'.
A Queensland member observes how this lack of growth has other potential economic outcomes 'With SMEs not growing, the flow on effect is that the order books are stagnant, no growth in GDP, they are not expanding their business, if anything they are contracting their business and this impacts importers, manufacturers, and all businesses associated with SME business and then this becomes a slow stagnated process and it will take a lot to get this rebooted.'

8. Conclusion

The round tables on Access of SMEs to Finance has provided an important and interesting insight into the current challenges being faced by SMEs. The participating members have provided valuable contributions that should be considered by all members working within this sector and we thank them for this.

Members participating in the round tables were invited provided concluding comments. The following comments broadly represent the views put across at the round tables:

- 'I think it is returning to normal – the pre GFC conditions were never going to be sustainable set of conditions. We are now in the phase where you need to have very good creditability with the bank. With limited funding from offshore banks available, it's not surprising that there is no money in Australia for easy lending. I am not sure what the answer is, but I suppose what I am saying is that I am not surprised by where we are.'

- 'The banks have been in a state of fear for about two years. The first year they were in a state of fear that they would collapse. Through that fear they started to put a lot of pressure on their clients, in particular the corporates, because that was where a lot of the money was outstanding. The corporates then responded to that by going to the equities market and paying back a significant proportion of the debt. So, when the banks say they have money to lend, that's right as a lot of their book has been repaid. The banks are now concerned that medium size businesses will also repay and this will mean that they will have too much cash. But the flip side to that is that they are too scared to lend because we are now passed the phase of 'everyone chip in' to get past the 'Oh my goodness' moments, to now 'Who's fault was it?''

- ‘Most SMEs have looked at it now and said being in a much more conservative debt/equity position makes sense. When tricky stuff comes your way, you don’t have as much debt on the books because it is too pricy when the trouble comes.’

- ‘Some of my clients are looking to stay in business only until they can sell and retire – there is no longer joy in running a small business – too much regulation, not enough return. They cannot get good staff to run the business. It is too much hassle and therefore they are not expanding. Most just want to cut back.’

From these views, it is apparent that the times have changed for SMEs and that a ‘new normal’ is probably going to be what they will have to work with.