# ACCI SUBMISSION TO

# PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS & FINANCIAL SERVICES

## INQUIRY INTO ACCESS FOR SMALL AND MEDIUM BUSINESS TO FINANCE

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# 1. EXECUTIVE SUMMARY

Since the onset of the global financial crisis, access to affordable finance has been an issue of significant concern for many of small businesses as major banks have become more risk averse and overly conservative in their small business lending. Accordingly, banks have increased their risk margins for small business loans and tightened their standards and terms for new loans through lower loan-to-valuation ratios, stricter collateral requirements and higher interest coverage requirements.

Unlike larger businesses, small businesses do not have the capacity to raise external finance through equity or corporate bond issuance and therefore rely heavily on intermediated finance from financial institutions for their working capital, new capital expenditure e.g. on machinery, plant and equipment as well as opportunities for overall expansion. Declining profits since the downturn, as evident from ACCI surveys, have continued to put downward pressure on small business retained earnings and further limited the sources of available finance.

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

While some businesses are being denied credit due to unsatisfactory financial performance, ACCI is concerned that even businesses with strong trading records and solid lending proposals are finding credit restricted due to weakened balance sheets, reduced revenues or cash flows, and/or falling real estate collateral values. Furthermore tighter credit standards imposed by major lenders have required small business owners to adjust their business strategies by delaying plans for expansion, downsizing, or in some cases closing an otherwise viable business.

Loans to the small business sector are especially vital to the Australian economy as they employ nearly 50 per cent of Australia's private sector workforce and produce around 40 per cent of private sector industry value-added. Thus a healthy small business sector is the key in ensuring the durability and sustainability of private sector-led growth, creating jobs and introducing innovation and productivity growth in the Australian economy.

ACCI makes the following recommendations both to ensure business borrowers have access to adequate and affordable finance as well as to promote greater competition in Australian banking system:

AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY

## 1.1 Major Recommendations

**Recommendation 1:** The Government should explore the feasibility of a temporary small business loan guarantee scheme. Such schemes operate in several jurisdictions including the US, UK and Canada with varying levels of eligibility and coverage. Proper design would be essential to avoid unintended consequences and such a scheme if implemented should be considered a temporary measure prior to the return of greater competition in the market place.

**Recommendation 2:** Based on current levels of competition, the Government should rule out any significant future merger and acquisition activity in the Australian retail banking system and the wider financial services sector which would consolidate the dominance of any one of the four major banks. ACCI would encourage initiatives to assist in the development of a 'fifth' or additional pillar to provide effective competition to the existing large incumbents.

**Recommendation 3:** The Government should promote a level playing field between major banks, regional banks, foreign owned banks and non-bank lenders. For example, by phasing out the interest witholding tax (IWT) on most forms of offshore borrowing by financial institutions more quickly.

**Recommendation 4:** Consideration should be given to explore new measures to reduce the cost of funding for Australian financial institutions especially the regional banks including:

- Equalising the fee applicable to the Australian Government Wholesale Funding Guarantee Scheme between the major banks and smaller ADIs; and
- Improving market liquidity by allowing Australian banks the capacity to issue covered bonds.

**Recommendation 5:** The Government should improve liquidity of the securitisation market through the Australian Office of Financial Management (AOFM) until normality returns to the securitisation market.

**Recommendation 6:** In the face of anticipated regulatory changes by international banking supervision agencies, Australian policymakers need to be aware that supervision and examination policies may unintentially impede banking competition as well as limit lending to small businesses. Care needs to be taken to ensure that more onerous Basel III rules applying to foreign

banks relative to our domestic institutions do not have the effect of reducing competition in our market.

## 1.2 Additional Recommendations

**Recommendation 7:** The Reserve Bank or other related government agencies should conduct a quarterly credit conditions survey on banks and non-banks to assess the trends and developments in credit conditions for households and businesses.

**Recommendation 8:** The Government should encourage clearer information on financial products and transparency in loan pricing to promote greater willingness of depositors or borrowers to switch between banks. Taxonomy on loan and other financial products should be standardised to enable easier comparison.

**Recommendation 9:** In addition to the parliamentary inquiry process, the Government should commission the Productivity Commission to conduct an inquiry into examining the degree of competition in the provision of business finance. The study should examine:

- The impact of an increasing/decreasing number of participants in lending markets;
- The implication of repricing of risk to businesses;
- The changes that have occurred in the cost and availability of finance to business, especially smaller enterprises, over time; and
- International experiences in encouraging banking competition and their advantages and disadvantages if applied in Australia.

# 2. ABOUT ACCI

## 2.1 Who We Are

The Australian Chamber of Commerce and Industry (ACCI) speaks on behalf of Australian business at a national and international level.

Australia's largest and most representative business advocate, ACCI develops and advocates policies that are in the best interests of Australian business, economy and community.

We achieve this through the collaborative action of our national member network which comprises:

- All state and territory chambers of commerce
- 27 national industry associations
- Bilateral and multilateral business organisations

In this way, ACCI provides leadership for more than 350,000 businesses which:

- Operate in all industry sectors
- Includes small, medium and large businesses
- Are located throughout metropolitan and regional Australia

## 2.2 What We Do

ACCI takes a leading role in advocating the views of Australian business to public policy decision makers and influencers including:

- Federal Government Ministers & Shadow Ministers
- Federal Parliamentarians
- Policy Advisors
- Commonwealth Public Servants
- Regulatory Authorities
- Federal Government Agencies

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

Our specific activities include:

- Representation and advocacy to Governments, parliaments, tribunals and policy makers both domestically and internationally;

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

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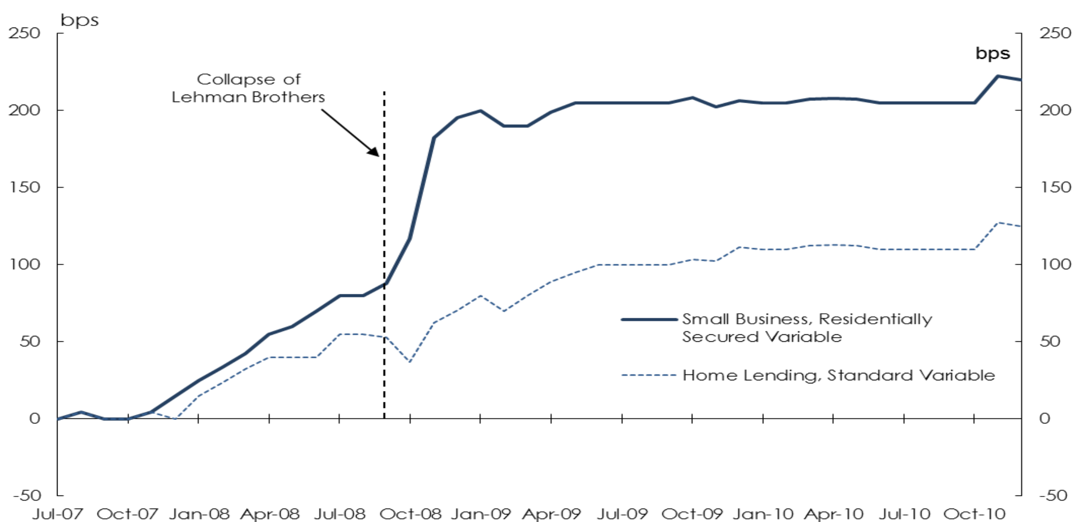
# 3. COST OF FINANCE

## 3.1 Interest Rate Charges

In the most recent 25 bps rate hike by the Reserve bank in November 2010, the major banks increased their standard variable mortgage rates by 35 to 45 bps, almost double the increase in cash rate. The major banks have argued that their funding costs have become more expensive which contradicts the Reserve Bank's findings that the major banks' funding costs have remained relatively stable in recent months.

Figure 1 below shows that following the November's lending rates increases beyond the Reserve Bank 25 bps rate increase, the cumulative change in small business variable rates and the standard variable rate on home lending has both jumped 17 bps to 222 bps and 127 bps respectively. Figure 1 clearly indicates that the increases in lending rates relative to the cash rate have been much larger for small business loans than housing loans since June 2007.

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




Source: RBA Statistical Table F05.

Data from the Reserve Bank indicates that small businesses were paying a margin of 4.17 percentage points above the cash rate on average for bank finance, compared to a margin of 2.23 percentage points for large businesses

and 2.47 percentage points for mortgage customers as of 2 February 2011, despite most of these small business loans being residentially secured[1].

Between 2000 and 2007, the net interest margins (NIMs) on major banks' Australian operations fell by around 100 basis points driven mainly by increasing competition. Despite the fall in NIM, sizeable reductions in bank's operating expenses allowed the banks to continue operating profitably[2].

However since 2008, the NIM has widened again. According to RBA estimates, the major banks' net interest margins (NIMs) have increased by 20 to 25 bps above pre-crisis level. It is ironic that the impact of the global financial crisis has been to increase banks' NIMs.

According to the September 2010 *RBA Financial Stability Review,* the NIMs of the major banks' consolidated global operations have increased by around 20 bps since the trough in 2008 but have levelled off a little recently. Over the same period, the NIM for their Australian operations is around 35 bps higher. This divergence reflects that banks have been less successful in recovering increases in their funding costs in overseas markets than the domestic market, which could be partly attributed to the decline in competition in the Australian financial system.

## 3.2 Banking Fees

In addition to higher interest rate charges, business borrowers have also faced higher bank charges or fees since the onset of global financial crisis.

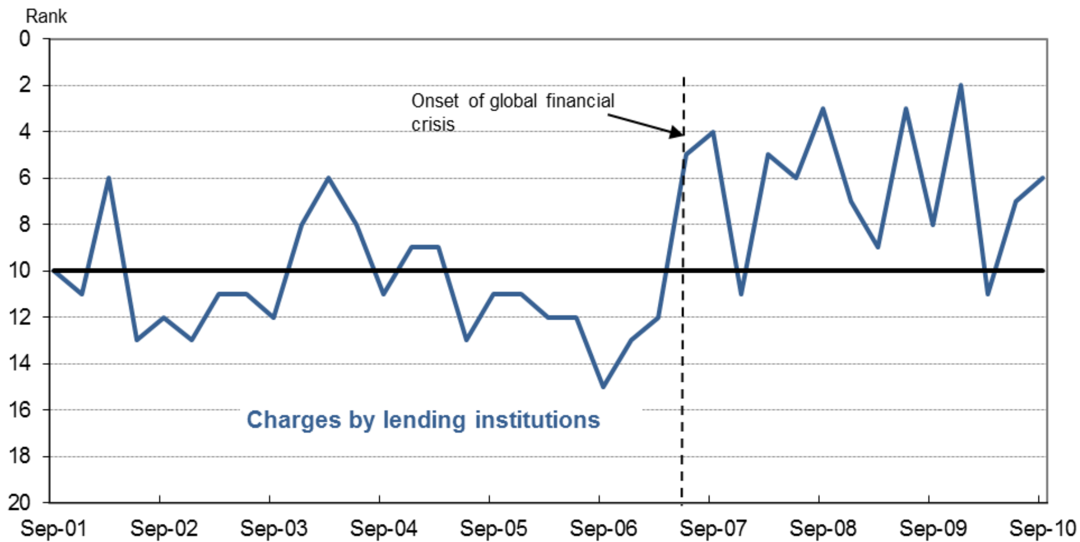
Since June 2007, the *ACCI Small Business Survey* found that *Charges by Lending Institutions* consistently ranked within the top ten constraints in small business investment in plant and equipment (see Figure 2).

---

[1] RBA 2011, *Statement of Monetary Policy February 2011*, page 48.

[2] Battellino, R. 2009, *Some comments on bank funding,* Remarks to the 22nd Australasian Finance and Banking Conference, 16 December 2009.

## Figure 2: Selected constraint on small business investment




Source: ACCI Small Business Survey, November 2010.

These findings are further supported by the recent RBA's annual survey of banking fees[3]. In 2009, the RBA found that total domestic fee income grew by 9 per cent in 2009 to $12.7 billion, with fee income from businesses growing much faster than fee income from households (see Table 1 and Figure 3).

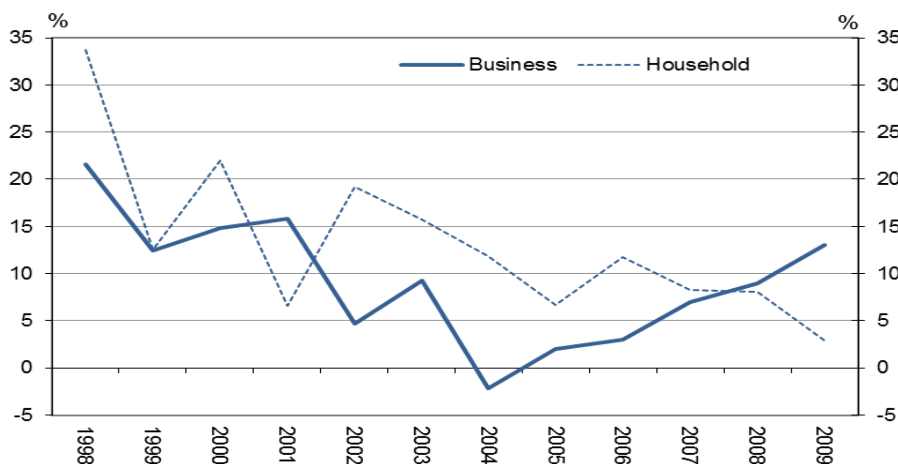
## Table 1: Banks' fee income

| | Households | | Businesses | | Total | |
|---|---|---|---|---|---|---|
| | $ bn | Growth (%) | $ bn | Growth (%) | $ bn | Growth (%) |
| 2007 | 4.5 | 8 | 6.2 | 7 | 10.7 | 8 |
| 2008 | 4.9 | 8 | 6.8 | 9 | 11.6 | 9 |
| 2009 | 5.0 | 3 | 7.6 | 13 | 12.7 | 9 |

Source: RBA 2010, *Banking Fees in Australia*, RBA Bulletin, June quarter.

[3] RBA 2010, *Banking Fees in Australia*, RBA Bulletin, June quarter, page 31 to 35.

## Figure 3: Growth in banks' fee income




Source: RBA Statistical Table F6.

In 2009, the banks' fee income from businesses increased by 13 per cent, much higher than its five year average growth of 4 per cent. As was the case in 2008, most of the growth in business fee income was from growth in fees from loans (up 20 per cent) and bank bill facilities (up 28 per cent). The RBA noted that the increase in fees on these facilities reflects the re-pricing of credit and liquidity risks; in particular, fees on undrawn loan facilities appear to have risen significantly.

Over the same period, the banks' fee income from households rose by 3 per cent, well below its five year average growth of 9 per cent and is the slowest rate of growth in household fees since the survey began in 1997. There has been strong growth in housing loan fee income (up 17 per cent) partially offset by a decline in deposit account fees (down 11 per cent), as banks compete heavily to attract retail deposits.

Case studies collected by ACCI members have also highlighted the issue of increasing bank fees:

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

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

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

# 4. DIFFICULTIES IN ACCESSING FINANCE

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

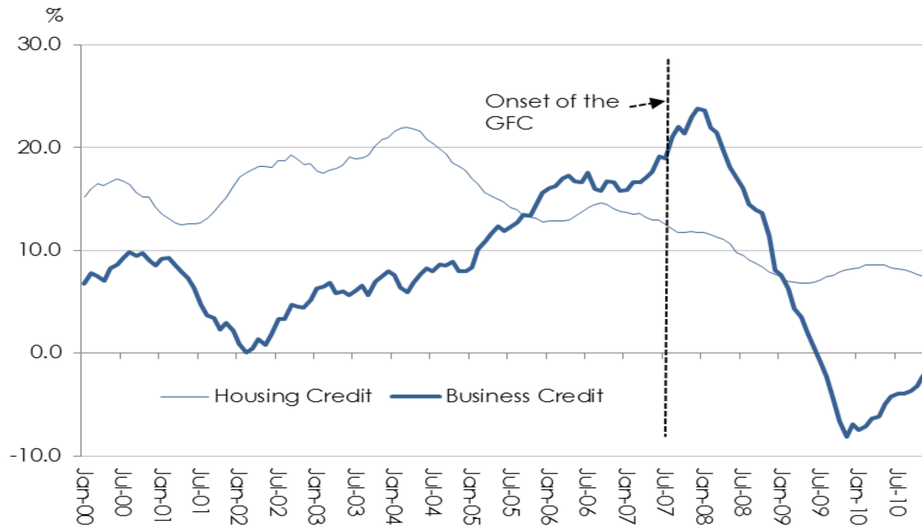
Tough lending criteria have been imposed on business borrowers since 2008, including higher serviceability or interest coverage ratios and lower loan to value ratios. It was indicated that in the case of commercial property, banks may only lend up to 65 per cent of the value used to secure a loan, compared to 80 per cent in the past[4].

While housing credit continued to grow in the aftermath of the global financial crisis, credit flows to businesses have fallen significantly (see Figure 4). Although total housing credit (owner occupied and investor housing) rose +7.3 per cent over the year to December 2010, business credit has fallen by 0.3 per cent in December 2010, to be -2.3 per cent lower through the year. This was the sixth consecutive monthly fall in business credit.

[4] Drummond, M. (19 October 2009), *Big banks put credit squeeze on small business borrowers,* the Australian Financial Review.

## Figure 4: Credit by sector

Year-ended percentage change

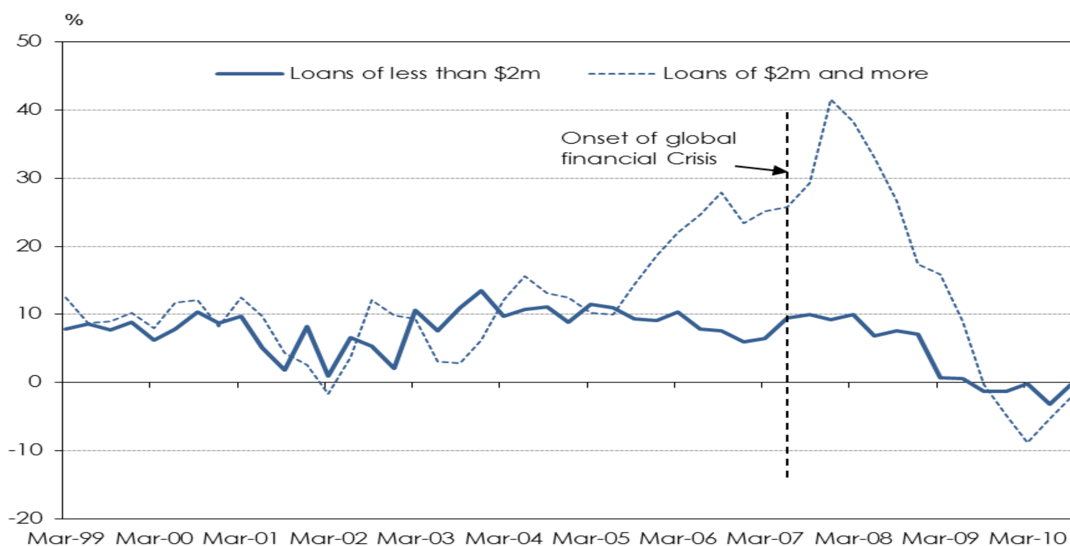



Source: RBA Statistical Table D1.

As the cost of intermediated finance has increased following the GFC, larger businesses have elected to diversify their funding by deleveraging their intermediated finance as indicated in Figure 5, whereby loans of $2 million and more have declined significantly since the crisis.

## Figure 5: Total credit outstanding to large and small business

Year-ended percentage change




Source: RBA Statistical Table, D08.

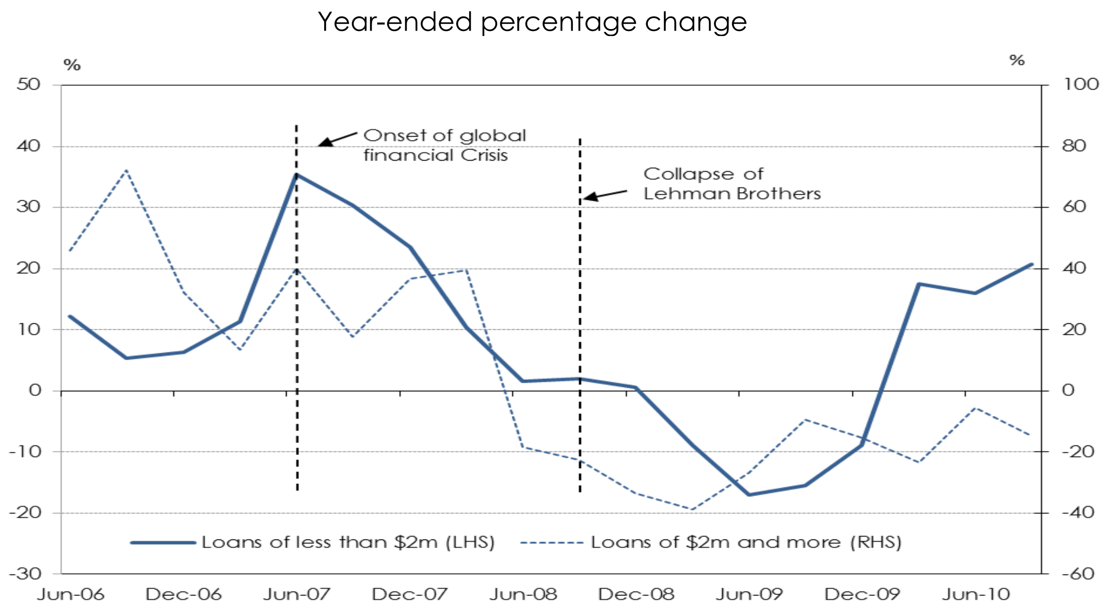
Large corporations re-adjust their balance sheet by relying on equity raisings and increasing their non-intermediated debt. As a source of external funds, the net amount of equity raising by large corporations amounted to 6 per cent of GDP in the six months to December 2009, up from an average of 2.5 per cent over the last decade[5].

However, it is concerning that credit flow to small business has also fallen significantly. Figure 5 shows that total bank lending to small business (i.e. total credit outstanding for loans of less than $2 million) has recorded negative annual growth since the September quarter of 2009.

New credit approvals to small businesses have also fallen since the onset of the crisis. Figure 6 indicates that year-ended growth for new bank lending to small businesses has fallen from a peak of 35.3 per cent in the June quarter of 2007 to 2.0 per cent in the September quarter 2008. After the collapse of Lehman Brothers in September 2008, new credit approvals fell to a trough of -17.0 per cent in the June quarter 2009, before recovering to a growth of 20.6 per cent in the September quarter of 2010.

## Figure 6: New loan approvals to large and small business

Year-ended percentage change




Source: RBA Statistical Table D08.

The RBA noted that while weak demand for credit has partly explained the low pace of growth in business credit outstanding since the GFC, it also

[5] RBA 2010, *Financial Stability Review*, September 2010, page 44.

reflects tighter financing conditions as banks' risk appetites decreased. However, in recent months, the RBA indicated that credit availability is improving and competition among lenders for some market segments is beginning to pick up[6].

Unlike larger business, small businesses rely on intermediated finance and their own retained earnings for working capital, investment and expansion. Credit rationing by the banks, through tighter lending criteria and repricing of existing and new loans, will constrain small business ability to invest, grow and employ.

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

> "[the] banking systems predilection for home loans was partly responsible for the lack of credit to small business and posed a long term risks for [the] economy.
>
> "A banking system which allocates capital away from the most productive areas of the economy – business – is ultimately bad for growth, bad for competition, bad for jobs, bad for business and in the end bad for Australia.
>
> "...international banking rules, known as Basel II, contributed to banks' preference for lending for mortgages because they must hold five times more capital to support the same size of loan to a business."[7]

## 4.1 What Business Tell Us

Given the lack of publicly available information on the issue of difficulty in accessing finance, in particular for small business, this section attempts to use business surveys and case studies to highlight the issue.

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

Table 2 shows that 25.4 per cent of respondents reported that changes in bank lending criteria negatively affected their capital expenditure plans in March 2010, an increase from 22.9 per cent reported a year earlier.

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[6] Ibid., page 45.

[7] Drummond, M. (18 February 2010), *Home loan bias bad for economy*, the Australian Financial Review.

## Table 2: ACCI survey responses – Impact on CAPEX

Per cent of Responses

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

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

Moreover, Table 3 shows that the percentage of businesses reporting a negative impact of tightening in bank lending criteria on their working capital has increased from 20.1 per cent in March 2009 to 26.0 per cent in March 2010.

## Table 3: ACCI survey responses – Impact on working capital

Per cent of Responses

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

Note: See Table 2.

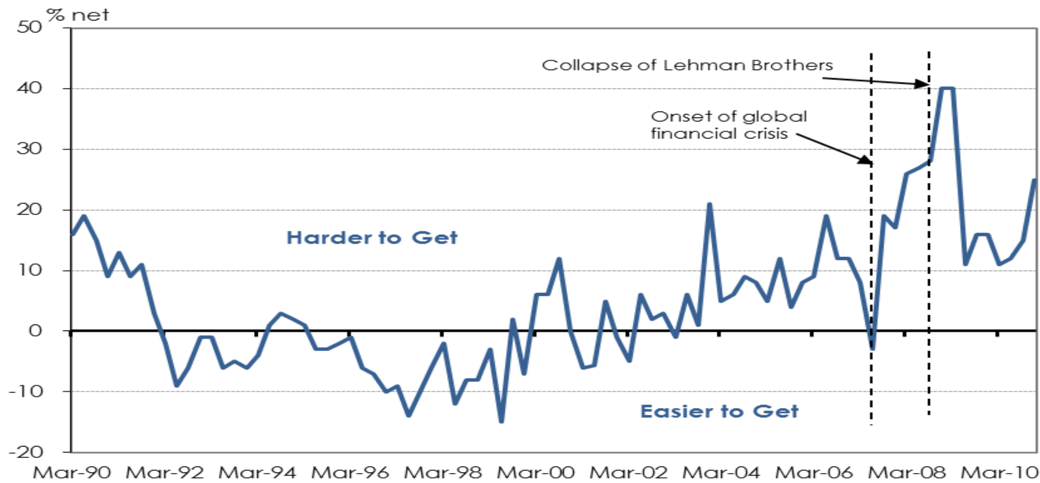
The above tables clearly demonstrate that while the economy begins to recover, more businesses are reporting the negative impact of difficulties in obtaining finance on their investment plans as well as their normal operating expenses.

The *ACCI – Westpac Survey of Industrial Trends* also found that more manufacturers are reporting that finance is harder to get since the onset of the global financial crisis. Figure 7 indicates that the net indicator of *Availability of Finance* reached a peak of +40 per cent in the December quarter 2008 and the March quarter 2009, significantly above its decade average of +10 per cent. In the December quarter of 2008, 45 per cent of manufacturers reported finance was harder to get compared to three months earlier, while only 5 per cent of respondents indicated that finance was easier to obtain.

While conditions improved in the second half of 2009, it is concerning that manufacturers have again reported increasing difficulty in accessing finance

since the June quarter of 2010, with a net +25 per cent of manufactures reporting finance harder to get over the December quarter of 2010.

## Figure 7: ACCI survey - Availability of finance




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

According to the latest PricewaterhouseCoopers October 2010 *Private Business Barometer*, which surveyed 1,092 businesses with turnover of between $10 million and $100 million during August and September 2010, private business reported that interest rate increases (46 per cent), availability of credit (37 per cent), cost of funding (37 per cent) and terms and conditions of available credit (33 per cent) are amongst the top impediments to meet their business growth targets in 2011.

The 2010 CPA Australia *Asia-Pacific Small Business Survey*, which surveyed small business[8] owners from Australia, Singapore, Malaysia and Hong Kong in October 2010, found that Australian small business has the highest reliance on credit cards for finance, at 62.6 per cent, compared to less than 45 per cent for small businesses in Singapore, Malaysia and Hong Kong.

This finding highlights that many Australian small businesseses are of the view that credit card finance is more easily accessible than other forms of bank credits, even though other forms of finance may be more appropriate for the circumstances. Heavy reliance of credit card finance also means that small business owners are paying more than double the interest rate charges for credit card finance than a residential-secured business loan, which puts significant pressure on small business.

[8] In the CPA survey, small business is defined as business with less than 20 employees.

The recent VECCI – Victoria University survey on small business access to finance, which surveyed 284 businesses in Victoria during June and July 2010, found that:

- 16 per cent of respondents indicated that inadequate access to finance was a major obstabcle to growth, while a further 18 per cent identified it as a moderate obstacle;

- 30 per cent of respondents indicated that they had passed up attractive business opportunities in the previous two years because attempts to access external finance were unsuccessful; credit was not available in sufficient quantities; finance was too expensive; or lending conditions were too strict;

- businesses within the manufacturing industry and the construction sectors face larger obstacles in accessing finance than firms in the services sector. For example, 44 per cent of manufacturing firms (62 respondents) and 50 per cent of construction and utility-related firms (18 respondents) reported that access to finance was a major or moderate obstacle, compared to 28 per cent of firms in the business and personal services sector;

- financial obstacles were greatest amongst firms with annual revenue between $0.5m and $1m (46 per cent of cohort). When considering firm size, those with 5 to 14 employees reported the highest level of financial obstacles (40 per cent of cohort); and

- of those reporting forgone investment due to inadequate access to finance, 39 per cent of businesses were 6 to 10 years old, 35 per cent were up to five years old, and 26 per cent were more than 10 years old. These findings suggested that it is not the new, micro businesses that have struggled most in terms of accessing finance, but SMEs that are in the early-mid expansion phase.

ACCI acknowledges that banks should be prudent when assessing business loan applications due to the underlying business risk. However, it is concerning that there are businesses with viable business plans that are unable to grow and expand due to inadequate access to finance as highlighted in the following case studies[9].

[9] These case studies were collected for the March 2010 *Senate Economics Committee Inquiry into Access for Small Business to Finance*.

- **Case Study A[10]**: Business A is a SME incorporated in 1997 with three shareholders governed by a board of six. It provides engineering products and services. Sales and profits have increased over recent years including solid profit performance over the year to June 2009.

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

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

- **Case Study B:** Business B took over a business in 2006 with a $500,000 turnover per annum and in 2009/10 the turnover is estimated to be $2.2m. Given the business is growing and expenses have increased due to expansion, Business B has applied for additional credit facility from Bank Z that it has been dealing with for the past 13 years. However Bank Z could not see Business B's growth prospect and has withheld from increasing its overdraft limit, line of credit and credit card limit to assist with paying the expenses. This has caused a significant cash flow problem for Business B.

The case studies above highlight examples where small business owners are facing significant difficulties in accessing finance from major banks for business expansion, investment and short-term cash flow assistance. These difficulties even occurred when the customer has had a long established relationship and a history of meeting commitments. Our business feedback

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

indicates these are consistent problems amongst many small and medium sized enterprises.

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

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

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

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

# 5. BANKING COMPETITION

Since the onset of the global financial crisis (GFC) in mid-2007, competition in the Australian banking system has diminished significantly as most of the non-bank financial institutions that relied on the securitisation market and foreign banks have exited or reduced lending in domestic markets. There is also the impact of the more recent acquisition of the St. George Bank and Bankwest by the major banks.

Reflecting these developments, the major banks have increased their mortgage market shares from 57 per cent in August 2007 to 74 per cent in August 2009; while the market share of foreign banks fell from 8 per cent to 5

per cent and non-bank lenders' market share fell from 15 per cent to 11 per cent[11].

Moreover, the major banks have increased their market share in business lending, accounting for around 75 per cent of lending to unincorporated businesses and around two-thirds of total business credit[12].

Richardson (2010) estimated that the largest four banks alone made an underlying profit of around $35 billion before tax in 2009, of which $20 billion per annum in his view is likely to reflect the banks' monopoly power over the Australian payments system[13].

## Table 4: Big four banks profits in recent years

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

Source: Richardson (2010), page 4.

Table 4 shows that 2009 was a record year for major banks with an underlying profit of $35.1billion. This translates to a 26.4 per cent return on the banks' shareholder equity of $133.1billion. According to Richardson:

> "The rates of return earned by the banks (26.4 per cent using pre-tax underlying profit) can be compared with the rates of return earned elsewhere in the economy, which are estimated at approximately six to seven per cent. The average increase in the ASX accumulation index since December 1979 gives a figure of 12.3 per cent for big companies in general. However, as these figures include the banks' results, they are higher than they might otherwise be.
>
> "A second interesting comparison can be made with the alternative uses of their capital that other investors have to consider. The risk-free alternative use of capital can be taken to be represented by the 10-year government bond rate, which was 5.56 per cent in January 2010 and has averaged 5.65 per cent since January 2000. Adding a reasonable margin for risk implies a target rate of return at around the eight to nine per cent level.

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

> "These figures suggest that the underlying rate of return on equity in banks is at least 15 per cent higher than it might be in a truly competitive market, from which it can be inferred that the monopoly profits of the big four banks are around $20 billion, close to half the Commonwealth Government's total GST collections in 2008–09 and well over the $15.8 billion collected in fuel excise."[14]

Other studies on bank competition in Australia also found that Australia's bank revenues appeared to be earned under monopoly or conjectural short run oligopoly conditions for the period between 1998 and 2005, as the Australian banking sector is dominated by a small number of large banks[15].

According to the Boston Consulting Group (BCG) report, Australia's banking industries achieved an above-average total shareholder return (TSR) of 61.5 per cent in 2009. Australia had the highest average annual TSR of 9.2 per cent from 2005 to 2009[16].

For the first time, each of the largest four banks in Australia ranked among the 30 largest banks in the world[17].

For a third consecutive year, Australia together with Canada and Spain had the most profitable banking sector among the ten major markets in the world. In 2009, the Commonwealth Bank of Australia (CBA) was among the top ten large-caps banks with an estimated alpha of 33.9 per cent, the second best performer after Goldman Sachs. This estimate indicates that CBA had a 33.9 per cent risk-adjusted excess return on investment above market prediction[18].

ACCI fully supports and acknowledges the need for a strong and profitable banking sector. Indeed the stability of the sector relative to international developments helped secure our response to the global financial crisis and allowed us to recover more quickly and less affected than all other advanced economies. Nevertheless, we are concerned about diminishing competition in retail banking and the likely detrimental impact on business borrowers.

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[14] Ibid., page 6-7.

[15] Chan et al., 2007, *Bank competition in New Zealand and Australia,* Paper presented at the 12th FINSIA-Melbourne Centre for Financial Studies Banking and Finance Conference, 24-25 September 2007.

[16] Boston Consulting Group (BSG) 2010, *After the Storm: Creating Value in Banking 2010*, February 2010, Massachusetts, USA, page 14.

[17] Ibid., page 19.

[18] Ibid., page 20-21.

## 5.1 Decline in the Securitisation Market

Before the GFC, the growth in Australian asset-backed securities (ABS), most of which was residential mortgage-backed securities (RMBS), was particularly strong (see Table 5).

### Table 5: Australian asset-backed securities

| | Outstanding ($bn) | | Share (per cent) | | Annual growth (per cent) | |
|---|---|---|---|---|---|---|
| | Jun 2007 | Oct 2009 | Jun 2007 | Oct 2009 | Jun 2007 | Oct 2009 |
| RMBS | 176 | 102 | 63 | 66 | 27 | -21 |
| CMBS | 12 | 7 | 4 | 4 | 78 | -23 |
| CDOs | 18 | 10 | 6 | 6 | 44 | -22 |
| ABCP | 68 | 30[a] | 24 | 19 | 91 | -29 |
| *of which:* residential mortgages[b] | 42 | 22 | | | | |
| Other ABS[c] | 9 | 8 | 3 | 5 | 17 | -3 |
| **Total** | **283** | **157** | **100** | **100** | **29** | **-22** |

Source: Debelle, G. 2009, *Wither securitisation?*, Address to the Australian Securitisation Conference 2009, Sydney, !8 November 2009.

Notes: RMBS – Residential mortgage-backed securities; CMBS – Commercial mortgage-backed securities; CDOs – Collaterised debt obligations; ABCP – Asset-backed commercial paper.
(a) Latest value is for August 2009, corresponding share and growth rate are calculated using these data.
(b) Includes RMBS.
(c) Mainly bonds backed by leases, receivables and motor vehicle loans.

The rapid growth in securitisation as indicated in Table 5 before the GFC was mainly due to[19]:

- Strong demand for housing finance;
- Increased competition from mortgage originators, which typically relied on securitisation for funding;
- The desire by banks to diversify their funding; and
- Investor demand or appetite for high-yielding AAA-rated securities, making this a cost-effective way of raising funds for many borrowers.

[19] Black, S., Brassil, A. and Hack, M. 2010, *The impact of the financial crisis on the bond market*, RBA Bulletin, June quarter 2010, page 56.

By mid-2007, asset-backed securities had grown to 30 per cent of the stock of Australian non-government bonds outstanding, bonds issued by Australian financial institutions were 40 per cent, bonds issued by Australian non-financial corporates were 18 per cent, and Kangaroo bonds[20] were 13 per cent.

However, the onset of the GFC has led to a sharp fall in the issuance of asset-backed securities. Since mid-2007, quarterly issuance of RMBS has averaged $3 billion compared with the average quarterly issuance of $15 billion in the two years prior to the GFC. The dislocation of the securitisation market in the aftermath of the GFC has forced many non-bank lenders such as mortgage originators, which relied entirely on the securitisation market for funding, to reduce their lending to households.

As a result, the major banks have increased their market presence and shares of the mortgage market. The major banks have increased their share of the mortgage market from 57 per cent in mid-2007 to 74 per cent in August 2009. In contrast, the share of housing loans funded by securitisation fell from almost 25 per cent in mid-2007 to around 10 per cent in early 2010[21].

Moreover, the global increase in risk and risk aversion has also caused the cost of lower-rated corporate bond issuance to increase sharply and for a period some corporates had difficulty accessing the offshore bond market. As a result, many corporates turned to banks for intermediated finance, which have crowded out bank funding for small and medium sized enterprises (SMEs).

Therefore, the return of a well-functioning securitised debt market is important to ensure competition in the mortgage market, which in turn will provide more incentive for banks to increase their business lending to SMEs.

## 5.2 Bank Funding Costs and Net Interest Margins

The decision of the major banks to increase their standard variable mortgage rates[22] by more than the 25 basis points cash rate hike by the Reserve Bank in November 2010 has re-ignited public debate on banking competition. In their press statements, the major banks have argued that the recent increase in bank funding costs has prompted them to increase their mortgage rates.

[20] Kangaroo bonds are Australian dollar bonds issued in Australia by non-residents.
[21] Ibid., page 57.
[22] As at 11 November 2010, the CBA and the ANZ have increased their standard variable mortgage rates by 45 and 39 basis points respectively.

However, in the most recent September 2010 *Financial Stability Review*, the Reserve Bank noted that interest receipts from the core lending business of the major banks have been sufficient over the past two years to fully recoup higher funding costs and partly offset the rise in loan losses. Therefore, the net interest income, which represents the major banks' main source of revenue, has continued to underpin the profitability of the major banks, unlike for many of the largest global banks which have branched out into relying more heavily on trading and investment income[23].

In the November 2010 *Statement of Monetary Policy*, the Reserve Bank also noted that on aggregate the major banks' funding costs have been little changed over recent months, though trends differ for individual banks depending on their mix of funding. This finding is inconsistent with the recent public commentary of the major banks.

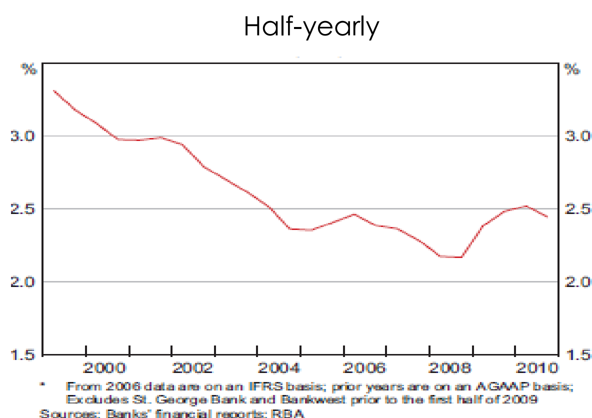
Moreover, the net interest margins (NIMs) – the margins between the average interest rate on bank loans and the average cost of funding – of the major banks have increased to about 20-25 basis points above the pre-GFC levels in late 2009, despite the NIMs levelling off in recent months (see Figure 8). The major banks' higher NIMs have supported their return on equity, partly offsetting the negative effects of the cyclical increase in their bad debts expense and the additional equities that they raised during the downturn[24].

According to a recent KPMG survey, Australia's major banks have posted record profits of $28.5 billion for the 2009-10 financial year, an increase of 26 per cent on 2008-09 results. The major banks' return on equity also increased from 13.7 per cent in 2008-09 to 15.9 per cent in 2009-10[25].

[23] RBA 2010, *Financial Stability Review*, September, page 20.
[24] Brown, A., Davies, M., Fabbro, D., and Hanrick, T., 2010, *Recent developments in banks' funding costs and lending rates,* RBA Bulletin, March Quarter, page 35-44.
[25] KPMG survey of *Major Australian Banks Year End 2010*
http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Press Releases/Pages/Record-profits-but-3-Nov-2010.aspx

**Figure 8: Major banks' net interest margins**

Half-yearly




# 6. BASEL III REQUIREMENTS

In December 2009, the Basel Committee on Banking Supervision[26] announced a series of proposals aimed at making the global banking system more resilient. The measures are intended to strike a balance between financial innovation and sustainable growth, with five main proposals to:

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

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

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

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

e. account for procyclicality and systematic risk by requiring that banks build up capital buffers during good times which could be drawn upon during periods of stress[27].

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[26] This Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision.

[27] Boston Consulting Group (BSG) 2010, *After the Storm: Creating Value in Banking 2010*, February 2010, Massachusetts, USA, page 10.

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

The 2010 Boston Consulting Group (BCG) report, which modelled the potential effects of the above proposals on 32 large banks across 12 countries – including Australia's largest four banks, estimated that[28]:

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

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

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

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

> "…Banks will need to raise more capital in order to maintain their existing business models, or they will have to limit the scope of their activities to stay within the confines of the remaining capital base. The former will dilute current shareholdings, while the latter will impair revenues and profits. Under either scenario, investors will see a significant decline in the value of their shares. Stock prices could fall by about 12 to 25 per cent as a result of the dilution of shares if banks were to raise the amount of capital described above [US$280billion to US$650billion]…" [29]

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

Under the new Basel III rules and requirements released in December 2010:

- by 1 January 2015, banks will have to meet the *Liquidity Coverage Ratio* (LCR) rule that requires them to maintain an adequate level of high quality liquid assets, essentially government bonds, that can be converted into cash to meet their liquidity needs for a 30 calendar day

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

time horizon, under a significant stress scenario in which the funding market frozen.

Under the current Australian Prudential Regulation Authority (APRA) requirement, banks only need to hold enough liquid assets for five days. APRA has indicated that the major banks on average have just 38 per cent of the liquid assets they will need to meet the new Basel III requirement[30].

- by 1 January 2018, banks will have to meet the *Net Stable Funding Ratio* (NSFR) requirement, which requires banks to hold a minimum acceptable amount of stable funding (e.g. shareholder equities and liabilities with effective maturities of one year or greater) based on the liquidity characteristics of their assets and activities over a one year horizon.

Given the shortage of suitable government bonds in Australia, Australian banks were allowed in the final Basel III deal to make up the shortfall of liquid assets by signing a 'commitment' contract in which the Reserve Bank promises to provide specific amount of extra cash during a crisis for a fee.

While the precise implications of the new Basel III are not yet fully known, analyses by major investment banks have shown that the earnings impact on banks will depend on the special liquidity facility fee charged by the Reserve Bank. With the implementation of the new Basel III rules[31]:

- JP Morgan estimated that bank earnings would fall by 1.1 per cent, based on an assumption of a 44-basis point fee; and
- Credit Suisse estimated that imposing a 50-basis point fee would erode the big four banks' earnings by $640 million or 2.7 per cent of 2010-11 earnings, while a 100-basis point fee would wipe out $1.28 billion of 5.4 per cent of 2010-11 cash profit.

Banks have indicated that the new Basel III rules, especially the liquidity requirement, will raise their funding costs, forcing them to raise mortgage rates more quickly and by a higher amount than the Reserve Bank's hikes in cash rate[32].

[30] Winestock, G. (6 January 2011), *No escape from new bank rules*, the Australian Financial Review.
[31] Ibid.
[32] Ibid.

Industry is concerned that business access to intermediated finance would be increasingly difficult, if the new Basel III rules further exacerbated banks' preference bias towards home loans instead of business loans.

Under the current Basel II rules, banks hold a minimum 8 per cent of their calculated risk-weighted assets in the form of capital. Given business loan is higher on the credit risk spectrum, it attracts a 100 per cent risk rating, implying that the full 8 per cent capital has to be set aside for business loans. In contrast, home loans attract 35 to 100 per cent risk rating depending on the loan-to-valuation ratio, implying that only 2.8 per cent of capital needs to be set aside for a conservative home loan.

These prudential capital requirements have increased the risk and costs for business loans and ACCI is concerned that the Basel III requirements will put small business borrowers at a substantial disadvantage compared to mortgage borrowers and larger corporates, with the flow on impact of higher funding costs and bank charges as well as further tightening in non-price lending requirements imposed on the small business sector.

# 7. POLICY OPTIONS TO IMPROVE BUSINESS ACCESS TO FINANCE

This section discusses some policy options that may improve business access to affordable finance and promote banking competition.

## 7.1 Government Guarantee on Small Business Loans

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

Many countries have extended and diversified their government guarantee loan schemes to alleviate small business credit constraints following the GFC, for example[33]:

- In the United States, the Small Business Administration (SBA), a US government agency that has provided support to small business

[33] For detailed discussion on international experienced in small business loan guarantee, please refer to Appendix A.

since 1953, guarantees loans made to small businesses by financial institutions. Following the GFC, the SBA temporarily increased the maximum guarantee on its 7(a) Loan Program, which is designed to assist start-ups and existing small businesses, to 90 per cent;

- In the United Kingdom, the *Enterprise Finance Guarantee*, managed by the Department for Business Innovation and Skills, provides a loan guarantee scheme to facilitate business lending to SMEs; and

- In Canada, the Canadian government guarantees 85 per cent of loans made by eligible financial institutions to qualifying businesses under the *Canada Small Business Financing Program.*

While the coverage, eligibility and mechanism for these government guarantee schemes are different and have been structured to address specific difficulties faced by small businesses in each country, the governments recognise their role in increasing availability of credit to SMEs.

Given that Australian SMEs continue to face difficulties in accessing finance, ACCI considers that there is scope for the Australian government to explore the feasibility of establishing a similar small business loan guarantee scheme in Australia. Any small business loan guarantee programs should be temporary until normality returns to the credit market.

## 7.2 Credit Conditions Survey

At presence, there is a lack of publicly available information on changes in the availability of mortgage and business finance in Australia.

ACCI considers that the Reserve Bank should conduct a quarterly credit conditions survey on bank and non-banks to highlight the trends and developments in credit conditions for households and businesses. Similar surveys have been conducted by central banks in developed countries, such as the *Senior Loan Officer Survey* conducted by the US Federal Reserve and the Bank of Canada and the *Credit Conditions Survey* conducted by the Bank of England.

The publicly available information on the availability of finance will help inform policymakers on the needs for additional efforts designed to help borrowers especially the SMEs during economic downturn.

## 7.3 Improving Process and Transparency

Increased provision of easy-to-understand information about financial and product alternatives may promote greater willingness of borrowers to switch from one institution to another and increase competitiveness within the financial industry.

Borrowers are often not presented with a clear picture when assessing loan products. There are a wide range of fee and interest rate variations in the Australian market and borrowers usually need to make a trade-off between interest rates and fees, with a lower headline interest rate often attracting higher fees for application, valuation, legal, settlement and early termination fees.

Therefore, more transparency in the pricing of loan products such as fees and interest rates will promote greater borrower understanding and allow them to compare between loan products or financial institutions effectively.

Moreover, borrowers are faced with different loan products described in different terminologies which often create difficulty and confusion. Thus, standardised taxonomy on loan products especially on fees should be considered for easier comparison between products which enables borrowers to make fully informed decisions.

While the account switching package aimed at improving the efficiency and ease of changing or switching transaction accounts for financial consumers was announced in 2008, ACCI considers that a "switching package" that simplifies the administrative steps for switching loan products should also be promoted to encourage competition in the lending market.

## 7.4 Phasing out the IWT

Australia, unlike many other financial centres, levies interest withholding tax (IWT) on most forms of offshore borrowing by financial institutions.

Subject to any existing exemptions, IWT is levied on any interest paid by an Australian borrower to a non-resident lender. This includes interest paid overseas by Australian financial institutions when they borrow offshore or raise deposits directly from offshore customers.

IWT is imposed on non-residents at a rate of 10 per cent of gross interest, but is reduced to 5 per cent if the interest is paid by an Australian branch of a foreign bank to its parent. An Australian financial institution does not have to

pay interest withholding tax if the interest is incurred in carrying on business outside Australia through a permanent establishment.

IWT has increased the cost of capital for Australian based banks borrowing offshore, especially for local subsidiaries of foreign banks and branches of foreign banks. Moreover, the application of withholding tax to some but not all offshore borrowings by Australian based banks for use in Australia has resulted in significant competitive distortions and inconsistencies. The *Australia as a Financial Centre* report (the Johnson Report) highlighted that:

> " … Australian banks have access to pools of overseas savings through their offshore banking operations. In a number of cases, these potential offshore savings pools are well beyond what they can use in the country of source, and hence could be used to support their lending and leasing arrangements conducted out of Australia. For Australian banks with a substantial presence in the region and a large number of retail deposit bases across a number of countries, this source of funds can be accessed and will avoid withholding tax due to the bank's ability to pool the funds. For other banks with a more limited network of retail depositors in the region, this may not be possible or, at best, the tax consequences may be ambiguous. In the Forum's view, these differences in tax treatment are arbitrary and undesirable…"[34]

In the 2010-11 Federal Budget, the Government announced that:

- The rate of IWT will be reduced from 5 per cent to 2.5 per cent in 2013-14 and to zero in 2014-15 for Australian branches of overseas financial institutions with respect to borrowings from their parents; and

- The rate of IWT will be reduced from 10 per cent to 7.5 per cent in 2013-14, then to 5 per cent in 2014-15 for other offshore borrowings by financial institutions, including local subsidiaries of foreign banks.

While ACCI welcomes the budget measures, the Government should quicken the pace of phasing out the interest withholding tax as recommended in the Johnson Report (Recommendation 3.4). This is to ensure a level playing field between foreign banks and Australian owned banks, as the current IWT arrangements disadvantage Australian branches and subsidiaries of foreign financial institutions, as offshore borrowings from their parents are often a significant source of funding for the loans they make.

[34] Australian Financial Centre Forum 2009, *Australia as a Financial Centre: Building on Our Strengths*, Canberra November, page 67.

## 7.5 Improving the Liquidity of the Securitisation Market

The onset of the GFC has led to a sharp fall in the issuance of asset-backed securities, with the quarterly issuance of residential mortgage-backed securities (RMBS) averaging just $3 billion since mid-2007, compared with average quarterly issuance of $15 billion in the two years prior to the GFC.

This dislocation of the securitisation market has forced non-bank lenders, which relied on the securitisation market for funding, to reduce their lending to households. The return of a well-functioning securitisation debt market is important to ensure competition in the mortgage market which will provide incentive for banks to increase their business lending to SMEs.

Therefore, the Government should improve liquidity of the securitisation market through the Australian Office of Financial Management (AOFM).

Over the year to September 2010, the AOFM has purchased around one quarter of the residential mortgage- backed securities (RMBS) issuance. While conditions in the securitisation market have improved, conditions remain challenging, with the market spreads on AAA-rated RMBS tranches at around 140 bps above bank bill rates[35]. According to bank sources, an increase in AOFM's holding of RMBS to $16 billion will reduce the market spreads to 80 bps.

## 7.6 Fees on Government Wholesale Funding Guarantee Scheme

The Australian Government Wholesale Funding Guarantee (hereafter the Guarantee Scheme) was announced in October 2008 in response to the extremely difficult conditions in the global financial system following the collapse of Lehman Brothers. The Guarantee Scheme ensured that Australian financial institutions were not placed at a disadvantage compared with their international competitors that could access similar government guarantees on bank debt.

Under the Guarantee Scheme, eligible authorised deposit-taking institutions (ADIs) have been able to offer government-guaranteed wholesale funding

[35] RBA 2010, *Financial Stability Review*, September 2010, page 27.

with maturity out to five years[36]. These arrangements became operational on 28 November 2008.

The Guarantee Scheme shared many features with wholesale guarantee arrangements announced in other countries, albeit on balance, it was more flexible and supportive:

- The Government did not set a fixed date for closure of the arrangements, announcing that the Guarantee Scheme would remain in place "until conditions normalise". On 7 February 2010, the Government announced that the Guarantee Scheme would close to new borrowing from 31 March 2010;
- The Guarantee Scheme has allowed guaranteed debt with a rolling maturity dates of five years, whereas most countries specified fixed maturity dates; and
- The fee applicable to AA-rated institutions (i.e. the major banks) under the Guarantee Scheme – 70 bps per annum, was at the low end of the international range for schemes with this structure. More importantly, the fee differential between institutions with different credit ratings under the Australian Guarantee Scheme was relatively large by international standards, with the fee for A-rated institutions at 100 bps and 150 bps for BBB-rated and unrated institutions.

The average daily value of guaranteed short-term wholesale liabilities peaked at $22.4 billion in February 2009 and has fallen to average $17.1 billion in January 2010.

Higher rated institutions, i.e. the major banks, have significantly scaled back their usage of the Guarantee Scheme and have been able to issue unguaranteed bonds since around the middle of 2009. However for lower-rated ADIs, there continues to be little unguaranteed bond issuance[37].

The fee differential between higher and lower rated ADIs has caused unintended consequences to overall banking competition, as smaller banks have to incur a higher guarantee fee, 30 to 80 bps higher, than the major

[36] Foreign bank branches have had restricted access to the Guarantee Scheme including a shorter maturity limit. The differing treatment reflects that, unlike the foreign bank subsidiaries, foreign bank branches are not separate entities incorporated and independently capitalised in Australia, instead they are part of the foreign bank incorporated overseas.

[37] Schwartz, C. 2010, *The Australian Government Guarantee Scheme*, RBA Bulletin March Quarter 2010, page 19-26.

banks. As such the regional banks have not been able to compete effectively with the majors due to the higher funding costs.

The equalisation of the fee applicable to the Australian Government Wholesale Funding Guarantee Scheme between major banks and regional banks will reduce smaller banks' lending rates. According to industry sources, if the guarantee fee were equalised to 70 bps for all institutions, its standard variable rate would fall by 10 bps. However the impact will vary according to the amount of guaranteed bonds issued and credit rating of the ADIs.

## 7.7 Issuance of Covered Bonds

Covered bonds have been identified as additional sources of funding and liquidity to the ADIs. Similar to the RMBS, covered bonds enable the financial institutions to obtain a lower cost of funding. However covered bonds are considered to be less risky than the RMBS.

Covered bonds are issued directly by financial institutions and the bonds are covered by a pool of mortgage loans. If the issuing institution collapses, the bonds are 'covered' by the pool and are separated from the institution's other assets to pay back the bond holders. In other words, covered bonds provide investors with extra protection as they are secured against the financial institutions' loan book.

However, the Australian Prudential Regulation Authority (APRA) is of the view that covered bonds are not consistent with depositor preference provisions set out in the Banking Act and hence are prohibited. Section 13A(3) of the *Banking Act 1959* states that:

> "If an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI."

As such covered bonds are inconsistent with the Banking Act requirement that all assets must be available to meet deposit liabilities before all other liabilities, since covered bonds have priority over certain assets on the balance sheet in the pool.

While covered bonds would enable the banks to reduce their funding costs, a competitive market is still important to ensure that these savings are passed on to borrowers.

Therefore, it is important that extensive studies are undertaken to examine how covered bonds would benefit and enhance competition in the

Australian financial system and how both investors who invest in covered bonds and depositors in the ADI would be protected.

# 8. ACCI RECOMMENDATIONS

Affordable and adequate bank loans to the small business sector are especially vital to Australian economy as they employ nearly 50 per cent of Australia's private sector workforce.

Therefore, ACCI proposes that:

## 8.1 Major Recommendations

**Recommendation 1:** The Government should explore the feasibility of a temporary small business loan guarantee scheme. Such schemes operate in several jurisdictions including the US, UK and Canada with varying levels of eligibility and coverage. Proper design would be essential to avoid unintended consequences and such a scheme if implemented should be considered a temporary measure prior to the return of greater competition in the market place.

**Recommendation 2:** Based on current levels of competition, the Government should rule out any significant future merger and acquisition activity in the Australian retail banking system and the wider financial services sector which would consolidate the dominance of any one of the four major banks. ACCI would encourage initiatives to assist in the development of a 'fifth' or additional pillar to provide effective competition to the existing large incumbents.

**Recommendation 3:** The Government should promote a level playing field between major banks, regional banks, foreign owned banks and non-bank lenders. For example, by phasing out the interest witholding tax (IWT) on most forms of offshore borrowing by financial institutions more quickly.

**Recommendation 4:** Consideration should be given to explore new measures to reduce the cost of funding for Australian financial institutions especially the regional banks including:

- Equalising of the fee applicable to the Australian Government Wholesale Funding Guarantee Scheme between the major banks and smaller ADIs; and

- Improving market liquidity by allowing Australian banks the capacity to issue covered bonds.

**Recommendation 5:** The Government should improve liquidity of the securitisation market through the Australian Office of Financial Management (AOFM) until normality returns to the securitisation market.

**Recommendation 6:** In the face of anticipated regulatory changes by international banking supervision agencies, Australian policymakers need to be aware that supervision and examination policies may unintentially impede banking competition as well as limit lending to small businesses. Care needs to be taken to ensure that more onerous Basel III rules applying to foreign banks relative to our domestic institutions do not have the effect of reducing competition in our market.

## 8.2 Additional Recommendations

**Recommendation 7:** The Reserve Bank or other related government agencies should conduct a quarterly credit conditions survey on banks and non-banks to assess the trends and developments in credit conditions for households and businesses.

**Recommendation 8:** The Government should encourage clearer information on financial products and transparency in loan pricing to promote greater willingness of depositors or borrowers to switch between banks. Taxonomy on loan and other financial products should be standardised to enable easier comparison.

**Recommendation 9:** In addition to the parliamentary inquiry process, the Government should commission the Productivity Commission to conduct an inquiry into examining the degree of competition in the provision of business finance. The study should examine:

a. The impact of an increasing/decreasing number of participants in lending markets;

b. The implication of repricing of risk to businesses;

c. The changes that have occurred in the cost and availability of finance to business, especially smaller enterprises, over time; and

d. International experiences in encouraging banking competition and their advantages and disadvantages if applied in Australia.

# 9. APPENDIX A: INTERNATIONAL EXPERIENCE IN ENHANCING BUSINESS ACCESS TO FINANCE

Unlike other economies such as the US, Canada, Japan, Korea and Singapore, Australia currently does not have a public or private organisation(s) mandated to provide financial support or assistance to SMEs. This appendix provides some international policies, practices and strategies that are aimed to enhance access to small business finance.

## 9.1 USA

The *Small Business Administration* (SBA) is a US government agency that provides support to small business since 1953. The SBA is created under the *Small Business Act* of July 30, 1953. Its function was to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns". The charter also stipulated that the SBA would ensure small businesses a "fair proportion" of government contracts and sales of surplus property[38].

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

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

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

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

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

corporations set up to contribute to the economic development of their communities;

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

d. **Disaster Assistance Loan Program**: This program provides low-interest loans to homeowners, renters, businesses of all sizes and most private non-profit organisations to repair or replace real estate, personal property, machinery and equipment, inventory and business assets that have been damaged or destroyed in a declared disaster.

As part of the *American Recovery and Reinvestment Act* following the crisis, the US government has made the following changes to the SBA's existing loan programs[39]:

a. permanently increase maximum loan size for:

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

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

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

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

c. temporarily allow small businesses to refinance existing, qualified, owner occupied and small business commercial mortgage into SBA 504 Loan structure. This initiative will temporarily support refinancing for small business owner-occupied commercial real estate (CRE) loans

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39 http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf

that are maturing in the next few years and help refinance over US$20b each year in CRE that might otherwise be foreclosed or liquidated; and

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

## 9.2 Canada

The *Canada Small Business Financing Program* (CSBF-Program) was established under the *Canada Small Business Financing Act* was enacted in April 1999, which build on the success of its predecessor, the *Small Business Loans Act*. The CSBF-Program's objectives are to streamline loan administration, improve its ability to achieve cost recovery and to extend financing that would otherwise have been unavailable to small-and medium-size enterprises[40].

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

Under the CSBF-Program:

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

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

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

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

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

After the crisis, the Canadian government announced further boost to the CSBF-Program under its 2009 Budget[41]. The Canadian government increased the maximum loan amount a small business can access under the CSBF-Program for loans made after 31 March 2009, from CAD250,000 to CAD500,000 for any one business, of which no more than CAD350,000 can be used for purchasing leasehold improvements or improving leased property and purchasing or improving new or used equipment.

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

## 9.3 Japan

The *Japan Finance Corporation* (JFC) is a public corporation wholly owned by the Japanese government, established on October 1, 2008, as the result of the integration of National Life Finance Corporation (NLFC), Agriculture, Forestry and Fisheries Finance Corporation (AFC), Japan Finance Corporation for Small and Medium Enterprise (JASME) and Japan Bank for International Cooperation (JBIC).

At present, *JFC Micro Business and Individual Unit* (JFC-Micro) is one of the units of JFC that specialises in financing for micro and small enterprises (MSEs)[42]. The following are the characteristics of JFC-Micro business loans:

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

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

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

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

Another division under the JFC is the *JFC Small and Medium Enterprise Unit* (SME Unit) which has taken over the responsibilities and operations of the

[41] Department of Finance Canada 2009, *Canada's Economic Action Plan: Budget 2009*, 27 January 2009, page 83.
[42] http://www.k.jfc.go.jp/pfce/loans/index.html

JASME, a government-affiliated financial institution originally established in August 1953[43].

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

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

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

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

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

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

## 9.4 South Korea

The *Industrial Bank of Korea* (IBK) was established in 1961 to promote and provide assistance to SMEs under the *Industrial Bank of Korea Act* and has been listed at the Korean Stock Exchange. The South Korean government holds approximately 76 per cent of the Bank's share as of the end of 2009[44].

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

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43 http://www.c.jfc.go.jp/indexe.html

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

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

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

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

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

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

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

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

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

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

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

The program is implemented through Corporate-Relationship Managers (Co-RMs), who are deployed to branches to share their expertise. IBK selects Co-RMs from among retired general managers of the branches, who have accumulated experience and know-how through many years of service at

the IBK. The Co-RM system is helping its clients to become more competitive, while at the same time enhancing IBK's asset quality.

## 9.5 Singapore

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

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

a. **Bridging Loan Program**: This program provides loans up to SG$2 million to locally owned or foreign SMEs for working capital purposes, including unsecured credit. The government's share of lending risk is 50 per cent[45];

b. **Local Enterprise Finance Scheme**: This program provides loans for the purchase of equipment and assets of up to SG$15 million to all locally owned companies. The government's share of lending risk is 70 per cent[46]; and

c. **Micro Loan Program**: This program provides loans of up to SG$100,000 for local SMEs with 10 or less employees. The fund can be used for daily operations and for automating or upgrading factory and equipment. The government's share of default risk is 70 per cent[47].

[45] http://www.spring.gov.sg/EnterpriseIndustry/FS/Pages/bridging-loan-programme.aspx#overview
[46] http://www.spring.gov.sg/enterpriseindustry/fs/pages/local-enterprise-finance-scheme.aspx
[47] http://www.spring.gov.sg/enterpriseindustry/fs/pages/micro-loan-programme.aspx

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