Australian Government

The Treasury

SENATE ECONOMICS COMMITTEE

ACCESS OF SMALL BUSINESS TO FINANCE

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INTRODUCTION

Small businesses are an important part of the Australian economy. According to the Australian Bureau of Statistics (ABS), the small business sector makes a significant contribution to economic growth, accounting for 39 per cent of total value added by industry in 2007-08.[1] It also plays a key role in generating jobs across Australia, accounting for 51 per cent of total employment in the economy as at 30 June 2008.[2]

Access to finance is important in allowing small businesses to maintain their total value added to the economy, and in allowing them to grow. The availability of reasonably-priced credit allows small businesses to expand their activities, fund new and innovative investments, smooth cash flows and maintain employment over the life of their business and across the business cycle.

This submission is structured in the following way. The first section provides some background on prevailing economic conditions, especially as they relate to small business. These conditions affect the availability, cost, terms and conditions of finance, as discussed in the second section. The third section discusses competition in small business lending and the Government's Guarantee Scheme for Large Deposits and Wholesale Funding (Guarantee Scheme) and Financial Claims Scheme. The remaining sections outline recent Government support for small business in Australia, and other actions taken by governments overseas.

This submission draws the following conclusions:

- Small businesses raise funding from a variety of sources, including internal funds, owner equity, venture capital and various forms of intermediated credit. However, due to their size and risk profile, small businesses' ability to raise funds from equity and wholesale debt markets are limited.

- There are signs that small businesses continue to have access to credit, albeit at less favourable conditions than existed prior to the global financial crisis. While the growth in small business credit has fallen, the volume of small business credit outstanding has not declined, suggesting that new borrowings have kept pace with loan repayments.

- The slowdown in small business credit growth reflects both demand and supply factors. While deleveraging by businesses and a contraction in business investment has reduced demand for credit, there has also been some tightening in the supply of credit, especially to certain high-risk sectors of the economy.

- Interest rates on small business loans have increased relative to the Reserve Bank of Australia cash rate. This largely reflects a combination of higher funding costs for lenders and higher expected risk of these loans. Going forward, as impairment rates

[1] Australian Bureau of Statistics (ABS) Catalogue Number 8155.0 – Australian Industry, 2007-08.
[2] Australian Bureau of Statistics (ABS) Catalogue Number 8155.0 – Australian Industry, 2007-08.

fall and the pressure on funding costs eases, it can be expected that these upward pressure on business interest rates will subside.

- Competitive pressures in small business banking have eased as a result of the global financial crisis. However, small businesses continue to have a wide range of products and providers. The Guarantee Scheme and the Financial Claims Scheme have enabled all authorised deposit-taking institutions to raise funds with which to finance new lending, including to the small business sector.

- Going forward, there are signs that small business conditions are recovering and lending margins are stabilising, and it is anticipated that credit growth will also recover as business investment rebounds. To the extent that funding markets continue to recover, competitive pressures in small business lending are also likely to improve.

- The Australian Government has undertaken a number of initiatives to support small business during the global financial crisis, including the Small Business and General Business Tax Break, investment in venture capital, small business advisory services, and support for small businesses' cash flows. Another initiative undertaken by the Government was the inclusion of an extra objective to support lending to small businesses in the second $8 billion investment in the residential mortgage-backed securities (RMBS) market. As a result, lenders who seek support under the RMBS program are asked to outline how active they are in lending to small business and to allocate part of the proceeds of their RMBS sales to those loans. It is expected that nearly 10 per cent of the funds raised so far under this second investment phase will be lent to small businesses.

- While these initiatives differ from overseas initiatives, they are tailored to reflect the Australian business environment. Care must be taken when looking to apply policies from overseas in the Australian context to ensure that they achieve the desired objectives, protect the interests of small business borrowers, and represent value-for-money for taxpayers.

There are a number of different definitions of a small business and no single definition is used in this submission. The ABS defines a small business as one which employs less than 20 people, while the Australian Tax Office uses a definition based on a turnover of less than $2 million. Private sector sources — such as the various market surveys of business conditions and activities — use other measures to distinguish small and large businesses. For the purposes of measuring credit, data published by the Reserve Bank of Australia facilitates the use of loans of less than $2 million as a proxy for the quantity of credit to small businesses, but individual lenders use different definitions when defining their small business customers. As such, both in this submission and more generally, the definition of a small business will often depend upon the context in which the term is used.

Business conditions following the onset of the global financial crisis

Australian businesses faced very challenging operating conditions through the global financial crisis and subsequent global economic downturn. Not only did the global financial crisis cause dislocation in global funding markets, but the subsequent economic downturn resulted in a reduction in demand for businesses' goods and services. However, there are recent signs that conditions have gradually begun to improve, reflecting in part the policy actions of both the Reserve Bank of Australia (RBA) and the Government.

Company profits fell by 16.5 per cent in the year to September 2009, matching the fall experienced in the 1990s recession and the equal weakest result since the modern form of the National Accounts was first published in 1959. Since then, company profits have shown signs of recovery, posting a 4.8 per cent increase in the December quarter 2009.[3]

Smaller businesses appear to have experienced a smaller decline in profitability than larger businesses. Gross mixed income, which includes the profits of small businesses, contracted by 1.7 per cent through the year to the March quarter 2009. Gross mixed income has since recovered significantly, growing by 5.1 per cent in the September quarter 2009 and by 3.7 per cent in the December quarter 2009.[4]

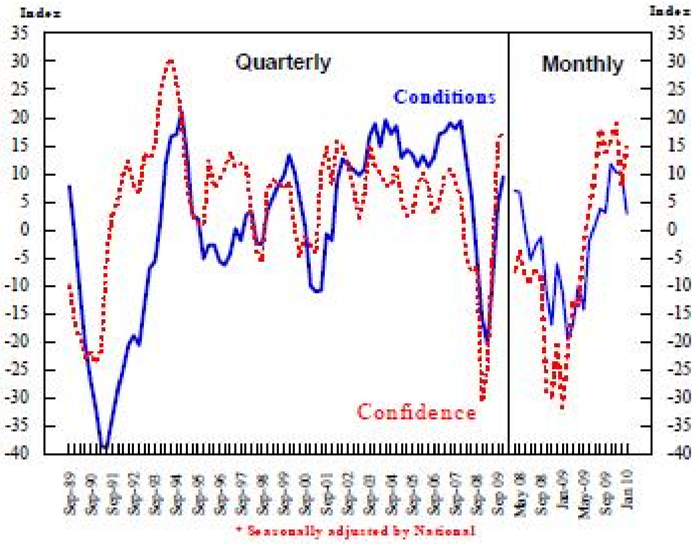
Business surveys have reflected the weakness in business operating conditions. However, they also contain some early indications that conditions may be gradually improving.

According to the National Australia Bank (NAB) survey, business confidence deteriorated rapidly over the course of 2008, reaching historically low levels by the December quarter 2008 (chart 1).[5] Similarly, the Australian Chamber of Commerce and Industry's (ACCI) quarterly survey of small businesses indicates that small business conditions fell to record lows in the March quarter 2009 (chart 2).[6]

Since this time, survey data indicates that business confidence and business conditions have rebounded strongly.[7,8] For example, the ACCI survey indicates that small business conditions are now the most favourable they have been since the December quarter 2007, and the NAB survey suggests that a majority of businesses expect conditions to improve throughout 2010.

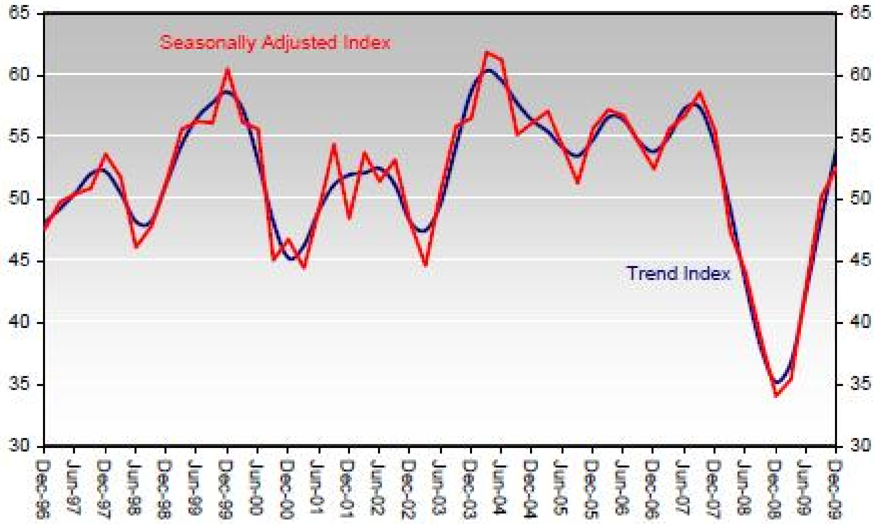
[3] ABS Catalogue Number 5206.0 – Australian National Accounts – December quarter 2009.
[4] ABS Catalogue Number 5206.0 – Australian National Accounts – December quarter 2009.
[5] National Australia Bank Quarterly Business Survey – various editions.
[6] Australian Chamber of Commerce and Industry – Small Business Survey – various editions.
[7] Australian Chamber of Commerce and Industry – Small Business Survey – various editions.
[8] National Australia Bank Quarterly Business Survey – December quarter 2009 and Australian Chamber of Commerce and Industry – Small Business Survey – various editions.

Chart 1: NAB small business confidence and conditions index



Source: National Australia Bank Quarterly Business Survey – December quarter 2009

Chart 2: ACCI small business conditions index



Source: Australian Chamber of Commerce and Industry – Small Business Survey – February 2010

SMALL BUSINESS FINANCING

The availability and cost of financing is a subset of the overall conditions affecting small business. The following sections will outline the structure of small business financing, the availability of credit since the global financial crisis and the pricing and conditions on that credit. In addition, it will outline the drivers of credit cost and availability, including the impact of macroeconomic conditions on financing demand and supply. Finally, it will outline the expectations for small business financing going forward.

Small businesses financing structures

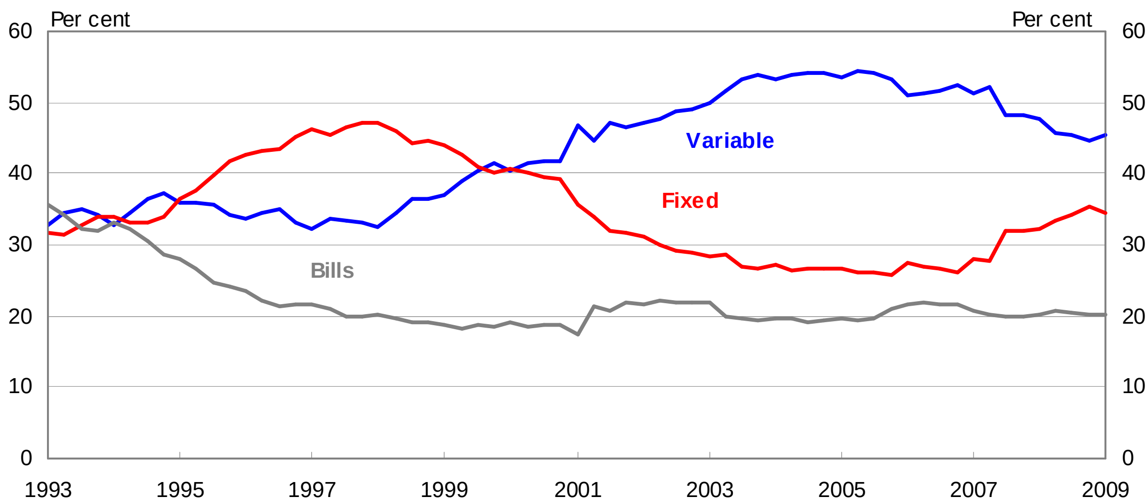
Small businesses access funding from a variety of sources, including internal funding, owner equity, venture capital, secured and unsecured intermediated credit, and bank bills. According to a survey by CPA Australia, of those businesses seeking additional funds over the 12 months to June 2010, 52 per cent were planning to obtain some from their own resources or friends and family, 61 per cent were planning to obtain some from a bank, and 20 per cent were planning to obtain funds from a non-bank or other source.[9]

Unlike many larger businesses, a number of small businesses are financed predominantly from internal funds and capital injections from their owners, without requiring significant external borrowings. Similarly, while large businesses can issue corporate bonds and equity as alternative sources of finance, small businesses' funding requirements tend to be too small to make such issuance cost-effective. Consequently, small businesses do not tend to access wholesale debt and equity markets.

When accessing credit from financial intermediaries, small businesses have increasingly obtained residentially-secured financing. Financial institutions first offered this form of financing in the mid 1990s, and it now makes up the majority of small business intermediated loans.[10] This form of financing involves using residential property, such as the owners' home, as collateral against the business loan, thereby sharing the risk of default with the lender. This can substantially reduce the cost of finance relative to unsecured borrowing. Similarly, many businesses finance their equipment through loans that are secured over the equipment purchased.

Partly reflecting the greater use of residentially-secured financing since the mid 1990s, variable-rate loans have become the predominant form of credit (chart 3). However, this share has declined since mid 2007, with fixed-rate credit increasing its share from around 26 to 34 per cent.

Chart 3: Composition of small business credit



Source: Reserve Bank of Australia.

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[9] CPA Australia, 2009. 'The CPA Australia Asia-Pacific small business survey 2009'.
[10] Reserve Bank of Australia, 1999, 'Recent Developments in Interest Rates on Bank Lending', and Reserve Bank of Australia 2010, 'Submission to the Inquiry into Access of Small Business to Finance'.

Availability of small business credit

The global financial crisis impacted on the flow of credit to business. Many businesses have reported that the availability of credit has tightened. A number of surveys have reported that businesses view credit as being more difficult to obtain, restraining their ability to grow. For example, NAB's monthly business survey reported that between 15 per cent and 26 per cent of businesses reported that it was more difficult to access credit in each of the first six months of 2009, while the Westpac-ACCI survey of Industrial Trends suggests that 5 per cent of total businesses view finance as a factor limiting production.[11]

Business credit contracted sharply following the onset of the global financial crisis, after having grown strongly over much of the past decade. The value of intermediated business credit outstanding contracted by 7.9 per cent through the year to February 2010, surpassing the weakness experienced following the 1990s recession.[12] This contraction suggests that businesses are repaying loans faster than they are borrowing.

However, it is difficult to establish the extent to which this contraction represents a decline in credit availability, compared with decisions by firms to reduce investment or diversify into alternative sources of funding. Despite the contraction in business credit, total external funding for business (including intermediated credit, bonds and equity) did not decline over the months to December 2009, as the decline in total intermediated credit was outweighed by an increase in equity and corporate bond issuance. For example, Australian companies issued a record $98.7 billion in additional (secondary) equity over 2009[13] and a record $29.6 billion in corporate bonds over the same period.[14]

In relation to the small business sector, small business credit outstanding has held up well relative to large business credit. For example, data from the Reserve Bank of Australia shows that the outstanding value of credit to small businesses[15] remained stable throughout 2009, after falling only slightly in 2008 (chart 4).[16] This suggests that small businesses have, in aggregate, at least maintained their existing level of borrowings and have successfully been able to refinance outstanding debt as it has fallen due.

Nevertheless, while small business credit outstanding has not contracted, growth in small business credit has fallen, suggesting that finance for new growth and investment may have slowed. According to RBA data, the small business sectors that experienced negative growth rates in 2009 were: finance and insurance; wholesale and retail trade; and transport and storage. In contrast, the value of outstanding loans to small businesses in the agriculture, construction and other sectors continued to grow over 2009.

As with general business credit, some of this slowdown is likely to reflect small businesses scaling back their investment plans or changing their funding arrangements. However, it appears that financing remains available to the majority of small business borrowers. For

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[11] Westpac and Australian Chamber of Commerce and Industry – Survey of Industrial Trends – March Quarter 2010.

[12] Reserve Bank of Australia – Financial Aggregates – February 2010.

[13] Australian Securities Exchange – Market Statistics. - http://www.asx.com.au/research/market_info/index.htm.

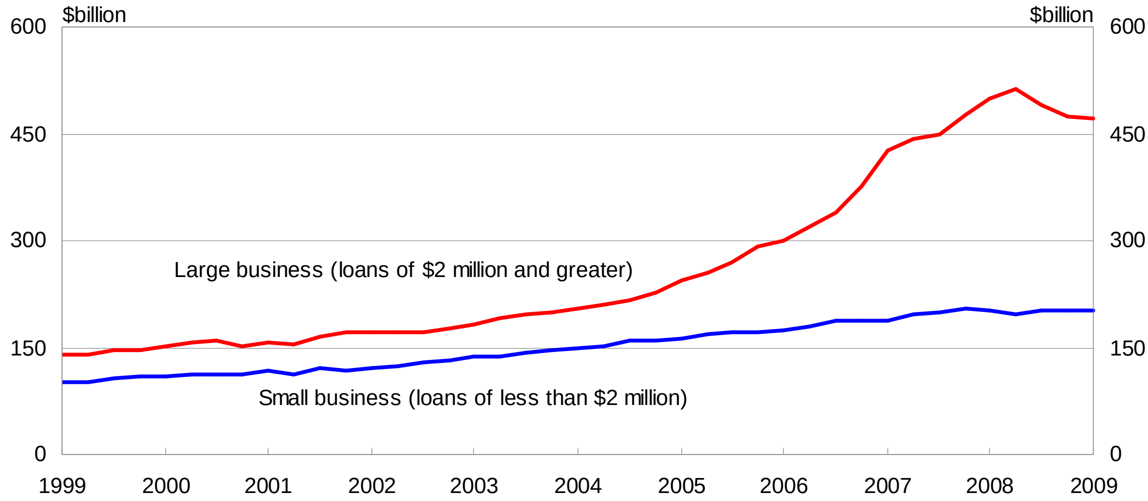
[14] Based on data provided by the Reserve Bank of Australia.

[15] Based on data for loans of less than $2 million.

[16] Speech by John Broadbent, "Reconnecting Corporate Australia with Frozen Credit Markets", Reserve Bank of Australia, November 2009.

example, the Government's credit complaints clearing house, designed to receive complaints from small businesses about access to finance, received a total of 74 complaints between March 2009 and March 2010. This hotline is open to all small businesses in Australia.

Chart 4: Credit to small and large businesses (loans outstanding)



Source: Reserve Bank of Australia.

Overall, while some small businesses may have experienced difficulty obtaining finance, it appears that most small businesses have been able to successfully negotiate access to credit, albeit in some cases under tighter conditions.

Pricing and conditions of small business loans

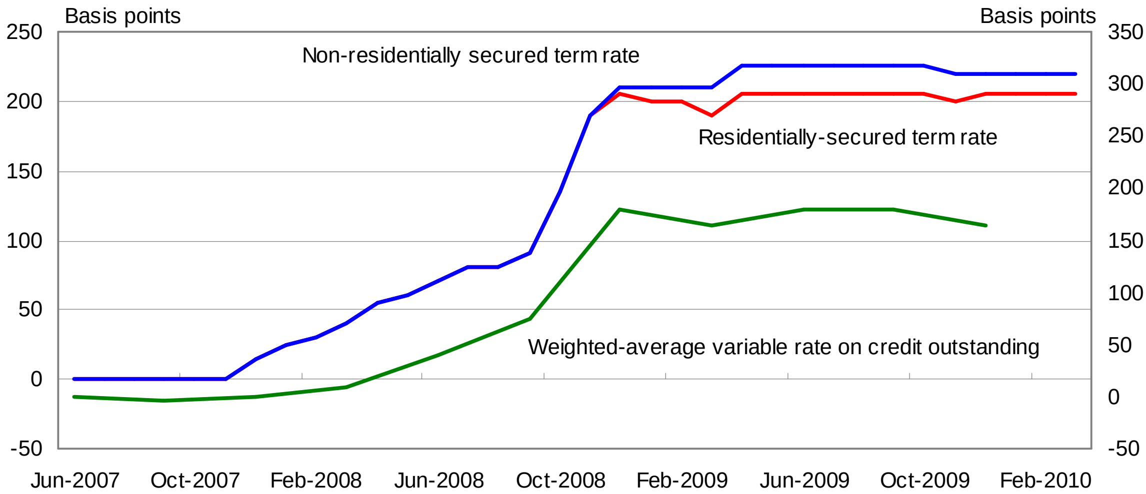
In addition to a slowdown in credit growth, small businesses have been affected by repricing and a change in loan conditions since the global financial crisis.

Small businesses have generally benefited from the loosening of monetary policy over the global financial crisis. From September 2008 to April 2009, the average small business residentially-secured term variable rate fell by around 300 basis points and the average non-residentially-secured term variable rate decreased by around 280 basis points, and the weighted-average variable interest rate on credit outstanding to small businesses fell by around 295 basis points.

However, small business variable rates have increased relative to the RBA's cash rate, with lenders increasing the spreads charged to small business borrowers, particularly for loans not secured by residential property (chart 5).

In previous easing cycles, reductions in the RBA cash rate have not been fully passed on to small business borrowers. For example, from February to December 2001, the RBA reduced the cash rate by 200 basis points from 6.25 per cent to 4.25 per cent. Over this period, the residentially-secured term variable rate fell by around 190 basis points, while its non-residentially-secured counterpart fell by around 175 basis points.

Chart 5: Cumulative change in spreads of variable lending rates to the cash rate since June 2007



Source: Reserve Bank of Australia.

Unlike variable-rate small business loans, the interest rate on fixed-rate products have a weak relationship to cash rate movements (particularly in the short-term) with banks' pricing new fixed-rate loans to reflect movements in longer-term money market yields, from where these loans are generally funded. Over the course of the global financial crisis the small business 3-year fixed interest rate continued to track closely with movements in the 3-year interest rate swap.

Survey data also supports the view that small business pricing and conditions have tightened, however do not represent the main constraints to investment. The April 2010 ACCI Survey of Investor Confidence listed Charges by Lending Institutions and Level of Interest rates as the eighth and tenth most important constraints on investment respectively.[17] Other surveys suggest that, in addition to repricing, many businesses experienced reviews of debt levels, requests for additional loan security, and a renewed focus on loan covenants by financial institutions.

Drivers of recent trends in business credit

The slowdown in small business credit growth over the course of the global financial crisis reflects both demand and supply factors.

On the demand side, business credit is closely tied to factors such as profitability, capacity utilisation and business investment intentions. The fall in capacity utilisation and business investment following the onset of the global financial crisis has translated into cyclically weak demand for credit. In addition, many businesses have sought to deleverage in the wake of the global financial crisis, to strengthen their balance sheets and manage their debt repayments in the face of a cyclical fall in profitability.

On the supply side, the availability, pricing and terms of small business credit have been affected by two key adjustments to the assessment and valuation of risk. The first is a

[17] Australian Chamber of Commerce and Industry – Survey of Investor Confidence – April 2010.

long-term increase in the global pricing of risk. The second is a cyclical reassessment of the riskiness of business lending, reflecting weaker economic conditions.

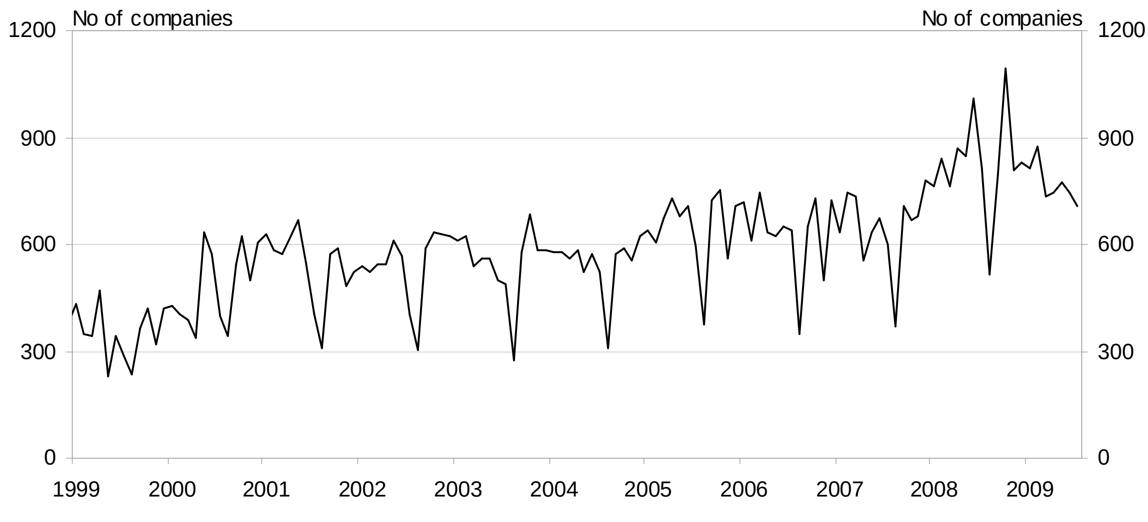
Firstly, prior to the global financial crisis, a period of global growth, low inflation and ample liquidity in global financial markets led to increased appetites for risk from lenders and investors, eventually leading to risk being underpriced. During this time Australian lenders had ready access to relatively cheap wholesale funding with which to lend to Australian households and businesses.

However, following the onset of the global financial crisis, Australian lenders experienced a reduction in the availability of wholesale credit, and an increase in its price. This placed upward pressure on interest rates, including interest rates on small business loans.

Secondly, some lenders have reassessed their lending programs. As with the demand for credit, the supply of credit is closely aligned with cycles in the economy, which affect lenders' eagerness for risk. Weaker economic conditions tend to reduce the credit-worthiness of potential business borrowers and increase impairment expenses for lenders. Lenders have historically responded to such conditions by scaling back lending to marginal borrowers, tightening the terms of lending such as through higher collateral requirements, and increasing the size of risk premiums charged to borrowers.[18]

The global financial crisis and the resultant economic downturn have represented such a period of increased cyclical risk to banks' business loan book. This increased risk is reflected in the spike in the rate of businesses entering administration in 2009 (chart 6) and the increase in banks' impairment expenses. Total impaired loans for the four major banks increased from an average of $0.7 billion in 2007 to an average of $3.4 billion in 2009, although there are signs that new impairment expenses have since declined.

Chart 6: ASIC reported companies entering administration per month



Source: Australian Securities and Investment Commission

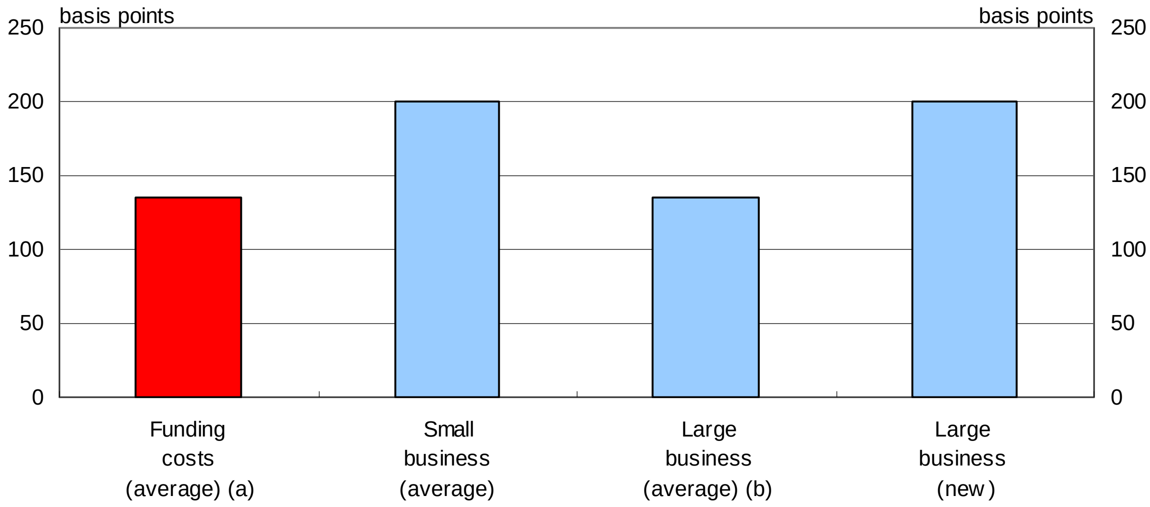
Lenders responded to the increased cyclical risk and higher anticipated impairment expenses resulting from the global economic downturn by increasing the risk margins

[18] RBA, 2010. 'Some Comments on Bank Funding', ***RBA bulletin***, March Quarter 2010, p.75. Available at: http://www.rba.gov.au/publications/bulletin/2010/mar/pdf/bu-0310-11.pdf.

charged to borrowers. Given that impairment expenses to date have largely centred on business loans[19], businesses have been more affected by loan repricing than home borrowers.

It is difficult to separately identify the impact that each of these two drivers has had on small business interest rates. According to RBA data, higher funding costs account for around 130-140 basis points of the increase in small business interest rates relative to the cash rate between mid-2007 and February 2010. The remaining 60-70 basis points appears to reflect higher margins on small business loans. According to the RBA, higher margins on business loans contributed to an increase in the major banks' net interest margins of around 20-25 basis points between the onset of the global financial crisis and the end of 2009, partly offsetting the negative effects of the cyclical increase in their impairment charges. Since that time, the major banks' net interest may have fallen slightly.[20]

Chart 8: Changes in spread to cash rate – Mid 2007 to Feb 2010



Source: Reserve Bank of Australia

(a) Figure represents the midpoint in the estimated range of 130-140 basis points.

(b) Figure is for total loans outstanding.

Expectations going forward

Despite the recent difficulties in the small business credit market, in general, the financial system, and domestic and global financial markets, continue to meet the needs of Australian businesses. In particular, banks and other lenders have raised significant new funds with which to finance their household and business lending, including almost $160 billion of long-term Government guaranteed funding.

Going forward, ***Mid Year Economic and Fiscal Outlook 2009-10*** estimates forecast that business investment will contract by 6.5 per cent in 2009-10, followed by a modest rebound of 5.5 per cent in 2010-11. Consequently, demand for credit and therefore credit growth is likely to remain subdued in the short term. Credit flows can be expected to slowly pick up as business investment recovers, and conditions in wholesale funding and

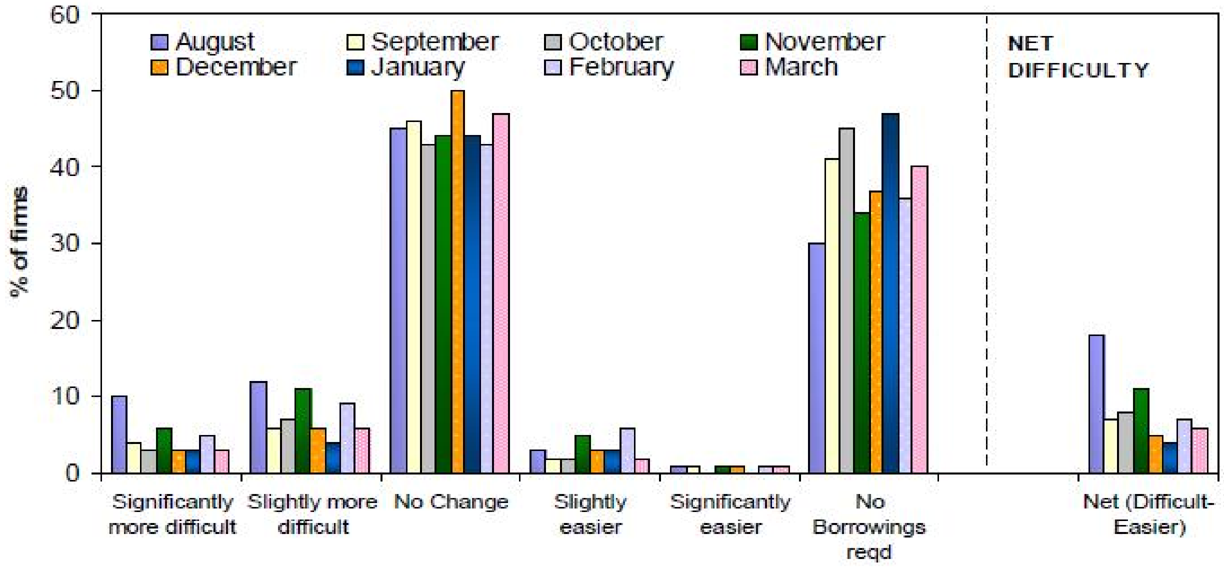
19 As noted in the annual reports of the four major banks.

20 Reserve Bank of Australia – 'Recent Developments in Banks Funding Costs and Lending Rates' and 'Some Comments on Bank Funding'– Bulletin – March Quarter 2010.

securitisation markets (including asset-backed securities and commercial mortgage-backed securities markets) keep improving.

There have already been some signs of improvement. For example, NAB's March monthly business survey indicated a further slight easing in net difficulty in obtaining credit. This survey measure has generally been trending downward over the past nine months, with January representing the lowest level of difficulty since the index began in October 2008 (chart 9). While the index was slightly higher in February and March, this may in part reflect the pickup in the proportion of businesses requiring new borrowings. This change in itself suggests that the deleveraging process may be moderating.

Chart 9: Availability of finance to business



Source: NAB Monthly Business Survey, March 2010

There are also signs that some of the upwards pressure on small business interest rates has begun to subside. For example, according to Cannex, between August 2009 and March 2010, the average increase in residentially secured variable business loans was 61 basis points, 14 basis points less than the movement in the RBA's cash rate. Moreover, 2 lenders reduced their interest rates over this period, and a further 2 maintained them at the same rate, notwithstanding the 75 basis point increase in the RBA's cash rate.[21] In addition, the spread between residentially-secured and non-residentially-secured term variable loans has narrowed slightly in recent months, after widening since the onset of the global financial crisis.

This easing of the upward pressure on interest rates may partly reflect the recent improvements in impairment expenses. Both CBA and NAB recently indicated that they expect their impairment expenses have peaked. Westpac also noted in its December quarter update that its impairment charges had fallen. To the extent that lenders expect their impairment losses to decline going forward, this can be expected to be reflected in the risk margins charged to small business borrowers, putting downwards pressure on interest rates.

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[21] Cannex 2010, Business Banking Star Ratings.

More generally, there are also signs that Australian lenders continue to support the small business sector. For example, in early 2009, a number of banks, including major banks, announced additional initiatives to support small business through the global financial crisis. While these varied depending on the institution, they included forums to provide advice to small businesses, discounted interest rates, improvements to e-commerce, employment of additional small business experts and relationship managers, and offers of assistance to small businesses experiencing hardship.

Nonetheless, as with other lending markets, conditions in the small business lending market are unlikely to return to the very buoyant levels experienced immediately prior to the crisis for some time. It is now widely recognised that these conditions reflected a systemic underpricing of risk in global financial markets, which is unsustainable over the medium term.

COMPETITION AND SMALL BUSINESS FUNDING

In addition to the drivers outlined in the previous section, competition in the market for small business finance can be a key factor affecting the price and availability of credit. Competition reflects not only the concentration in the market, but also contestability, including the opportunity for new players to enter and for existing players to grow.

The level of competition in small business finance

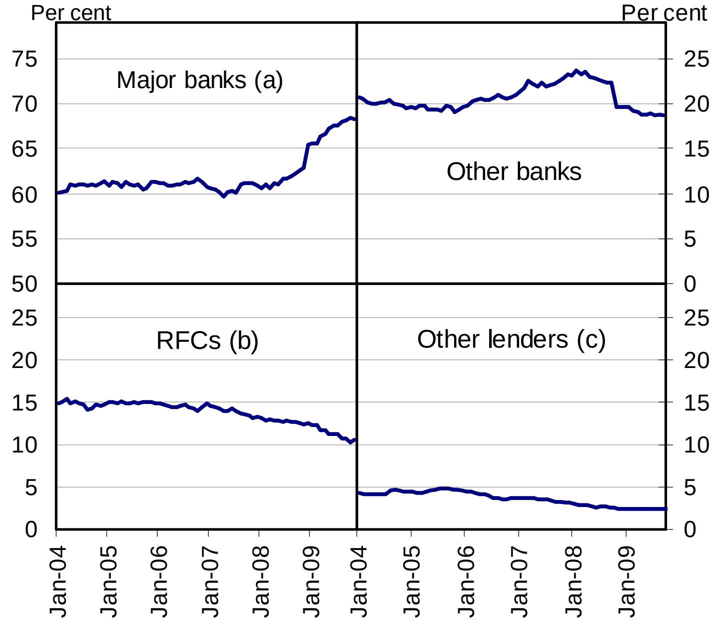
Competition involving financial products is important in ensuring that small businesses have the ability to access credit at the lowest possible prices.

Prior to the global financial crisis, major banks provided the majority of business finance, with other banks, registered financial corporations and other lenders taking lesser, but nevertheless substantial, roles. Since the crisis, non-major banks, registered financial corporations and other lenders have all reduced their market share (chart 10). This reflects a number of factors, including dislocation in funding markets and weaker conditions in foreign lenders' home economies that temporarily forced them to scale back lending.

Businesses have also been affected by the withdrawal of some of the non-bank sources of finance that existed prior to the crisis. For example, many equipment lessors and financiers have scaled back their lending as the result of the crisis. These have adversely affected competition in banking to business.

The market for small business financing has traditionally been more concentrated than for large businesses, as some lenders, such as foreign bank branches, have typically focussed on larger businesses and small businesses do not tend to have the same access to corporate debt and equity markets as larger businesses. Nonetheless, there continues to be a substantial number of providers of small business lending products (table 1).

Chart 10: Business finance outstanding



Source: Reserve Bank of Australia

(a) Includes BankWest from December 2008; and ANZ, CBA, NAB, St George and Westpac for the entire sample.

(b) RFCs stands for 'registered financial corporations'. The data covers all non-ADI financial corporations with assets over $50 million whose principal business in Australia is the borrowing of money and provision of finance.

(c) Includes lending by credit unions, building societies, cash management trusts, specialist credit card institutions and some additional securitisation data.

Table 1: Number of business loan products and providers

	Providers	Products
Small business commercial loans	30	40
Business term loans	25	65
Business overdraft loans	25	60

Source: Cannex

With impairment expenses stabilising, economic and financial conditions improving, and the health of smaller banks' balance sheets being restored, smaller players' ability to compete in the business lending market is improving. Some non-major banks in particular have noted that they are looking to increase their small business books. For example, Caroline Dunworth, a spokesperson for Bank of Queensland, recently stated that 'our strategic intent is to increase our SME (small to medium enterprises) market share,' and Suncorp noted in its 2009 annual report that 'we are now in a position to restore growth in our personal, SME and agribusiness target markets'.

In addition, a number of non-bank lenders are looking to increase their presence in the market. For example, over $2 billion of equipment asset-backed securities have been priced since September 2009, from financiers such as Capital Finance Australia, Macquarie Group and CNH Australia. Media reports also suggest that some commercial property management companies, such as Stockland, are providing finance to their small business tenants. Similarly, FlexiRent (an equipment finance company) is looking to expand its balance sheet over the coming months to take on more business leasing and vendor finance activity.

Going forward, increases in competition will not only help to ensure credit continues to be available to small business, but will also place downward pricing pressure on small business loans over the course of the recovery.

Effect of the guarantees on competition and small business funding

Under the Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme), the Government provided a guarantee for authorised deposit taking institutions' (ADIs') wholesale debt and large deposit obligations, for a fee. The Guarantee Scheme closed to new issuance of wholesale liabilities and additional deposit funds on 31 March 2010, however liabilities will continue to be covered under the Scheme for up to 67 months after this date.

The Guarantee Scheme has been critical in helping to support competition across all sectors of the banking market, including small business lending. It has supported the entire banking sector, by offering wholesale funding certainty to more than 150 Australian ADIs, including 14 Australian banks, 11 building societies, 110 credit unions, and 9 foreign bank subsidiaries.

The Guarantee Scheme allowed a broad range of institutions to raise funds in wholesale markets, and to continue to lend to Australian businesses, including small businesses. For example, as at 9 April 2010, non-major domestic banks hold A$65.2 billion in guaranteed liabilities. Without the Guarantee Scheme, banks (including both majors and non-majors) would have had no choice but to ration credit to businesses and consumers, and charge higher interest rates.

This certainty was further supported by the availability of free insurance of deposits of up to $1 million through the Financial Claims Scheme to all ADIs. As deposits make up a larger portion of smaller institutions' funding requirements than for larger institutions, this free guarantee particularly benefited mid-tier and smaller ADIs. Following the introduction of the Financial Claims Scheme, deposits at these smaller institutions grew at a faster rate than the major banks' deposits.

In addition to the Guarantee Scheme and Financial Claims Scheme, the Government's direct investment of up to $16 billion in the residential mortgage-backed securities (RMBS) market has enabled smaller lenders to lend at competitive interest rates and maintain a higher level of lending and market share than would otherwise have been possible. Applicants' small business lending commitments are taken into account under the second tranche of this initiative.

Closing the Guarantee Scheme

On 7 February 2010 the Government announced the removal of the Guarantee Scheme as of 31 March 2010. The Government took this decision on the unanimous advice of the Council of Financial Regulators that bank funding conditions had improved such that the

Guarantee was no longer needed. Importantly, Australia's financial regulators explicitly advised that removal of the Guarantee would not materially affect banking sector funding costs.

The removal of the Guarantee Scheme is not expected to impact on the availability of credit to Australian businesses, for a number of key reasons:

- with the assistance of the Guarantee Scheme, Australian ADIs issued a record $228 billion in long-term funding in 2009. Because of this, most banks are well ahead of their funding requirements, with some not needing to return to bond markets until 2011;
- the major banks are well capitalised and highly rated, and have already demonstrated their capacity to access non-guaranteed funding markets; and
- smaller ADIs are also well capitalised and their access to non-guaranteed funding markets is improving. Improvements in the Australian RMBS market, supported by the Government's expanded purchase of RMBS through the AOFM, will also provide alternative sources of funds for these ADIs.

GOVERNMENT SUPPORT FOR SMALL BUSINESS

The Government provides a range of support to small business, to help them access the advice they need, encourage investment in business innovation and reduce pressure on cash flow, particularly during the global financial crisis. While not all of these are directly targeted at access to finance, many of these measures would impact on small businesses' skills and cash flows which could assist when they seek commercial finance.

Small business financing

In addition to the Financial Claims Scheme and the Guarantee Scheme, the Government has undertaken measures to assist the flow of finance to small businesses in particular. As noted above, these included support for the RMBS market, which has been targeted to assist the flow of credit to small businesses, as well as supporting competition in the financial sector.

RMBS investment

On 11 October 2009, the Government announced an extension to its $8 billion investment in RMBS, originally announced in 2008. This extension includes an additional $8 billion to purchase new issuances of AAA-rated RMBS.

The extension to the RMBS program includes an additional objective of supporting lending to small businesses. Consequently, lenders who seek support under the RMBS program are encouraged to outline how active they are in lending to small business and to allocate part of the proceeds raised under the program to lending to small business. This is one of the factors that the AOFM assesses when deciding whether to support an RMBS deal.

To date, AOFM's investment of just under $1 billion of the additional $8 billion has allowed lenders to raise around $4.6 billion in funds. Based on information provided by these lenders to the AOFM, it is expected that over $400 million of these funds will be lent to small businesses.

Small business advisory services

Small businesses often seek advice on financial matters, including accessing external finance. The Government is funding a suite of measures to address these information needs. Initiatives include a network of small business advisory services, a small business support line, a one-stop-shop website, and assistance for small businesses to get on-line.

The Government provided $10 million in the 2009-10 Budget to establish the Small Business Support Line, which acts as a launching pad for small business owners seeking specialist advice in areas such as obtaining finance, cash flow management, retail leasing, personal stress and hardship, and marketing. The Small Business Support Line builds on the Government's 'one-stop-shop' website www.business.gov.au, which provides a large array of written advice including checklists for starting, running and exiting a small business, as well as how-to guides for accessing finance and links for accessing the nationwide network of government-funded Business Enterprise Centres throughout Australia.

Integrated into the support line is the credit complaints clearing house, established by the Government to receive complaints about access to and the cost of bank finance. Once a complaint is received by the clearing house, it is referred to the senior management of the bank in question for further investigation.

Small business investment

The Government has undertaken a number of initiatives to support small business investment through the global financial crisis, thereby also supporting demand for, and supply of, credit.

Small Business and General Business Tax Break

The Small Business and General Business Tax Break was a short-term stimulus measure which encouraged small businesses to bring forward and sustain capital expenditure during the economic downturn. This measure provided a bonus tax deduction for the cost of eligible assets acquired between 13 December 2008 and 31 December 2009, and installed ready for use by 31 December 2010.

The Tax Break was available for new tangible depreciating assets. This includes most types of equipment and machinery used by businesses.

Small businesses could claim a bonus deduction of 50 per cent of the cost of eligible assets. For all other businesses the deduction was 30 per cent for assets acquired between 13 December 2008 and 30 June 2009, and 10 per cent for assets acquired between 1 July 2009 and 31 December 2009.

Businesses claim the Tax Break in their tax return in the year that they first used the asset or had the asset installed ready for use. While the investment commitment time came to an end on 31 December 2009, businesses can still claim the Tax Break for assets acquired on or before this date and installed by 31 December 2010.

The Commonwealth Coordinator General's report on the progress of the Economic Stimulus Plan to 31 December 2009 stated that '$2.4 billion in deductions have been claimed to date under the Small Business and General Business Tax Break.'

Investment in Australia's venture capital market

The Government also supports access to financing for innovation by investing in Australia's venture capital market through the Innovation Investment Fund, which was allocated $224.7 million over 5 years in the 2006-07 Budget. In August 2009, a further $64 million was invested through the Innovation Investment Follow on Fund (IIFF) to support venture capital during the downturn. The IIFF is a temporary response to address the lack of capital available during the global financial crisis. The IIFF will enable previously supported companies to continue to develop and to commercialise research.

Small business cash flow

The Government has introduced various initiatives to support small businesses' cash flows throughout the global financial crisis, assisting them to meet their existing debt servicing obligations and their ability to service new debt.

These measures are in addition to the general economic stimulus measures, which supported small businesses' profitability and cash flow by stimulating economic growth. For example, the Government's cash bonuses to individuals assisted businesses, including small businesses, by boosting consumption and thereby improving growth and employment. Similarly, investment in infrastructure has assisted the business community, particularly the small business sector, which represents around 98 per cent of businesses in the construction industry.

The Australian economy would have contracted by around 0.7 per cent through 2009 in the absence of the fiscal stimulus measures, following the world's advanced economies into recession.[22]

PAYG instalments

The Government provided immediate and much needed cash flow relief to eligible small businesses by reducing their pay as you go (PAYG) instalment amount by 20 per cent for the quarter that included 31 December 2008. Broadly, the reduction applied to small businesses that make four quarterly PAYG instalments using the instalment amount calculated by the Commissioner of Taxation (Commissioner) and printed on their Business Activity Statement (that is, to those using the GDP-adjusted notional tax method).

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[22] Treasurer 2010, 'National Accounts – December Quarter 2009'.

To provide further cash flow relief to small business, the Government also reduced the PAYG instalment amounts for the 2009-10 income year for all taxpayers who pay quarterly instalments using the GDP-adjusted notional tax method. For the 2009-10 income year, the GDP adjustment factor used by the Commissioner in calculating quarterly instalments under the GDP-adjusted notional tax method was reduced from 9 per cent to 2 per cent. The Commissioner is also using 2 per cent instead of 9 per cent to calculate quarterly GST instalments in 2009-10.

The PAYG instalment reductions provided around 1.7 million eligible taxpayers with immediate and much needed cash flow relief during the global financial crisis by ensuring that their PAYG instalments more closely approximated their actual end of year income tax liability. This meant that small businesses and other eligible taxpayers had the use of what would otherwise be overpaid tax collections of around $440 million in 2008-09 and $720 million in 2009-10.

Small Business Assistance Program

The Small Business Assistance Program, managed by the Australian Taxation Office (ATO), offers a range of services that help new and existing small businesses. It delivers practical and tailored support to help small business understand their tax obligations and entitlements, establish good record keeping practices and manage cash flow effectively. Since July 2007, the Small Business Assistance Program has helped small business through a variety of means, including tax seminars, onsite visits to businesses, education calls and a support webpage.

Help for small businesses having difficulty paying their tax

On 1 June 2009, the ATO introduced two new measures to help eligible small businesses with an annual turnover of less than $2 million who are struggling to manage their tax payment obligations during the global financial crisis:

- Small businesses with an activity statement debt can apply for a General Interest Charge (GIC) free payment arrangement between 1 June 2009 and 30 June 2010. They will have the GIC remitted for a maximum period of 12 months, provided the mutually acceptable payment arrangement is maintained.

- Small businesses can also request a deferral of payment on eligible activity statements. Businesses with short term cash flow problems that pay quarterly and annually may be granted a deferral of up to two months, with those that pay monthly eligible for up to one month. No GIC applies for the period of the deferral, however activity statements still have to be lodged on time and businesses must make the deferral request on or before the original due date.

In the period 1 June to 31 December 2009 the ATO had agreed to 162,374 GIC-free payment arrangements to the value of $3.6 billion, and granted deferral of activity statement payment due dates in 3,261 cases.

Government guaranteed on-time cash payments to small businesses

To support cash flowing into small businesses, the Government has guaranteed on-time payment for new small business contracts (up to $1 million) with Government departments.

SMALL BUSINESS FINANCE INITIATIVES INTERNATIONALLY

Since the global financial crisis, a number of countries have implemented or extended programs to support small business. The Organisation for Economic Co-operation and Development (OECD)[23] has categorised the programs implemented by its members into four broad areas:

- measures supporting sales, cash flow and working capital;
- strengthening proinvestment measures;
- strengthening SMEs' capital base and private equity and venture capital; and
- enhancing SME access to liquidity, especially to bank lending.

There exists a wide range of measures under each area outlined above. However, among OECD countries, by far the most prominent measure has been the creation or extension of loan guarantee schemes. In addition, some countries, such as Germany, have created a 'development bank' as an alternative finance provider.

While Australia's economy has performed more strongly than those of other advanced nations since the onset of the crisis, the Government has established a number of initiatives to support small businesses under each of these categories, as discussed in the previous section. As in other countries, Australia's programs have been tailored to the specific needs of Australia's small business sector and the business environment, and regulatory and taxation framework in which it operates.

In considering further initiatives in these areas, it is important to take into account a number of factors, including:

- whether they address the underlying causes of the problem (for example, do they address the problem of poor business conditions or lack of demand);
- whether the initiatives are in the best interests of the businesses they are looking to assist, given Australia's particular business environment;
- where the benefits will accrue (for example, will benefits accrue to the borrower or the lender);
- will the initiatives lead to a broader market distortion; and

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[23] OECD, 2009. 'The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses'. Available at: http://www.oecd.org/dataoecd/40/34/43183090.pdf.

- whether the initiative represents good value for money for taxpayers.

Guarantee schemes

The majority of OECD countries have implemented or expanded existing guarantee schemes for small business loans since the onset of the global financial crisis. However, these schemes have generally been unsuccessful in stimulating credit to small businesses. According to the OECD, such guarantee schemes and extensions have not produced the desired results, and 'the stagnation in lending is true even of banks in countries where…credit guarantee schemes exist.'[24]

For example, the UK's pre-existing Small Firms Loan Guarantee has been replaced by an expanded loan program, known as the Enterprise Finance Guarantee. Despite this, business credit growth in the UK fell from levels in the order of 20 per cent to below zero following the onset of the crisis.[25] This program also represents a substantial cost to UK taxpayers, with the cost of defaults from the Small Firms Loan Guarantee scheme exceeding £68 million in 2007-08, out of total new lending of £207 million over the same period.[26] This is before administration costs are taken into account.

There are a number of constraints that may account for the general lack of success such guarantee schemes have had in stimulating credit. In addition, there are other considerations that must be taken into account when assessing the merits of such schemes. For example:

- where declines in small business credit are the result of declines in demand for finance, rather than a tightening of supply, a guarantee is unlikely to effectively stimulate credit flows;
- guarantees of credit do not stimulate demand in the economy, and therefore do not help small businesses generate profits with which to service additional debt; and
- guarantee schemes can be subject to adverse selection, where the least viable businesses obtain credit guarantees.

Development banks

In addition to guarantees, a number of countries including Canada, Sweden and Germany provide assistance to small business through Government-sponsored 'development banks'. These banks provide debt and equity for small businesses, including start-ups and other targeted business types.

However, it should be noted that in not all cases is finance provided directly by the development bank to the final borrower. German development bank KfW Bankengruppe,

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[24] OECD, 2009. 'The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses', p. 7. Available at: http://www.oecd.org/dataoecd/40/34/43183090.pdf.

[25] RBA, 2009. 'Financial Stability Review' September 2009. Available at: http://www.rba.gov.au/publications/fsr/2009/sep/pdf/0909.pdf.

[26] Department for Business, Enterprise and Regulatory Reform, 2008. 'Small Firms Loan Guarantee Annual Report for Financial Year 2007/08'. Available at: http://www.berr.gov.uk/files/file47204.pdf.

for instance, provides finance to commercial banks, rather than directly to the businesses. Commercial banks then extend loans to business borrowers, in most cases with an additional risk-adjusted margin over the interest paid to KfW Bankengruppe.[27]

Such banks can be used to fill a specific market gap. For example, Australia's Export Finance and Insurance Corporation (EFIC), provide financial services to Australian exporters. However, unless a specific market gap exists, the use of such banks can result in distortions in the financing market. Such distortions could include, for example:

- assisting lenders rather than borrowers, by providing a cheap source of funding that can be lent onwards at normal market rates;
- stimulating lending to borrowers who would not meet standard credit conditions, and who are not in a position to repay their loans; and / or
- 'crowding out' existing commercial providers of credit (or depositors and investors if loans are made through a commercial provider), leading to reduced competition.

Export Finance and Insurance Corporation

The Government provides insurance and financial services for Australian exporters and their financiers through EFIC. EFIC provides two major services to help Australian exporters, including small businesses, overcome financial barriers to overseas expansion.

A range of EFIC products support small businesses, however its core small business product is EFIC Headway, which offers a working capital guarantee to specifically help small businesses access additional working capital to expand their export business. However, EFIC has had limited demand for this facility, providing 25 of a targeted 43 EFIC Headway Facilities in the 2008-09 Financial Year at a total exposure of $17.4 million.

On 15 September 2009, the Minister for Trade announced an expansion of powers for EFIC to support small and medium enterprises seeking to establish supply and distribution facilities overseas, to harness the opportunities from the globalising economy.

The majority of these transactions are dealt with under EFIC's Commercial Account, in the event of a gap in commercial financial markets.

The EFIC arrangements are designed to address a specific market gap in the provision of finance and insurance to Australian exporters. Expansion of services to domestic businesses would require the identification of a clear market gap in the provision of finance to such entities.

In the absence of such a market gap, expansion of EFIC's activities would run the risk of crowding out commercial financial and insurance markets. It could also result in firms engaging in higher risk and otherwise unviable projects, diverting both private and taxpayer-funded resources away from more productive uses.

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[27] KfW Bankengruppe, annual report 2009.

CONCLUSION

All sectors of the economy, including small businesses, have been affected by the global financial crisis. In particular, there is some evidence that small businesses have been affected by a change in the price of credit and loan conditions. It is not clear how many small businesses have experienced difficulties in accessing finance, although it appears that financing remains available to the majority of small business borrowers.

The recent weakness in small business credit reflects a reduction in both demand for, and supply of, credit due to the cyclical economic downturn. It also reflects the reduced availability and higher price of credit, due to a shift to more sustainable global credit flows following a period where risk was systemically underpriced.

However, small business credit has held up relatively well over the past two years. This partly reflects the relative strength of the Australian economy and the stability of Australia's banking system, both of which were support by Government and RBA initiatives in response to the global financial crisis. In addition, as the economy recovers and impairment expenses fall, it is anticipated that credit conditions for small business will improve, and there are some signs that this is already occurring.

Concentration in small business lending has increased as a result of the global financial crisis. Nonetheless, small business borrowers continue to have access to a number of lenders and loan products. As funding markets continue to recover, competition in small business credit markets is likely to improve. This would further support downward pressure on prices and ongoing access to credit for small business over the longer term.

The Government has introduced a number of initiatives to support small business through the global financial crisis, including its investment in AAA-rated RMBS securities, the Financial Claims Scheme, the Guarantee Scheme, the Small Business and General Business Tax Break, venture capital investment, advisory services, guarantees of on-time payments, and support with managing their tax payments. These initiatives provide financing, investment, cash flow and advisory support to small business.

The Treasury

23 April 2010