Submission to the Senate Inquiry into access of Small Business to Finance

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As requested by the Secretary of the Senate Committee, I provide comments on the first three issues before the committee:

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

Excessive cost of credit could have adverse financial impact on the small business as such businesses are inherently vulnerable to failure due to small size of business. Bickerdyke et al. (2000) stated 'In 1998-99, key external factors — economic conditions affecting industry and excessive interest payments on loans — together accounted for around 22 per cent of all business-related bankruptcies'.

To get the feel of cost of finance to small businesses one needs to look at the interest on credit and fees charged by lending institutions. The data on interest rates was as under. The difference in weighted average interest rate on credit outstanding between small business and large business may be indicative of risk premium.

Table 1

Weighted average interest rate on credit outstanding

	per cent per annum		
	Small business	Large business	Risk Premium B -C
A	B	C	D
Jun-2001	7.90	6.35	1.55
Jun-2002	7.45	5.90	1.55
Jun-2003	7.20	5.90	1.30
Jun-2004	7.55	6.30	1.25
Jun-2005	7.60	6.40	1.20
Jun-2006	7.70	6.50	1.20
Jun-2007	8.10	6.95	1.15
Jun-2008	9.15	8.10	1.05
Jun-2009	7.10	5.15	1.95

(Source: Extracted from RBA statistical tables: Table 8 (col. A to C), other columns: author's calculation)

Following points emerge from the above data

- The risk premium was declining over the years since 2001. However, in the year ending June 2009 it has jumped up and was highest during the decade at 1.95 per cent.
- As small businesses are risky they attract risk premium, however, that makes achieving financial viability even harder for such businesses especially during times when the credit market is tight as it was during the GFC.

The data on fees is not publicly available. The terms and conditions and lending policies/practices would be internal to each lending institution and can't be commented upon.

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

Importance of reasonable access to funding

Access to credit is vital for survival and expansion of any business and particularly for small business. Several sources of funding other than credit are available for large businesses. These include raising equity through public offering, rights issues, or borrowing from the market directly instead of through an intermediary by issue of commercial paper or other debt instrument. As a consequence of the limited sources of funding available small businesses have to rely on owner's equity and credit from lending institutions.

The availability of credit to small businesses in Australia can be examined from the following data.

Small business loan outstanding

I consider loans below $2 million to be those for small business. The Australian Bankers Association also classifies small businesses accordingly. Table 1 below shows the small business credit outstanding as a proportion of total credit outstanding since June 2001.

Table 2

Total Credit Outstanding

$million

	Small Business	Large Business	All Business	Proportion SB to total B/D	Change in proportion	Growth in credit outstanding for Small Business YoY
A	B	C	D	E	F	G
Jun-2001	112346	158732	271078	41.44%		
Jun-2002	119805	164562	284367	42.13%	0.69%	6.64%
Jun-2003	128877	169694	298571	43.16%	1.03%	7.57%
Jun-2004	142788	196129	338917	42.13%	-1.03%	10.79%
Jun-2005	158431	215628	374059	42.35%	0.22%	10.96%
Jun-2006	170805	268675	439480	38.87%	-3.49%	7.81%
Jun-2007	187076	338002	525078	35.63%	-3.24%	9.53%
Jun-2008	199842	449745	649587	30.76%	-4.86%	6.82%
Jun-2009	201111	489927	691038	29.10%	-1.66%	0.64%

(Source: Extracted from RBA statistical tables: Table 8 (col. A to D), other columns: author's calculations)

Following points emerge from the data presented in the above table.

- Column E: The proportion of credit outstanding for small business to total for all business declined sharply over the years. Till June 2005 the small business credit outstanding was above 40 per cent of the all business credit outstanding. During the crisis years, June 2008 and June 2009 a sharp decline can be seen and for the first time the small business credit outstanding proportion declined to below 30 per cent.
- Column F: This column indicates the change in proportion indicated in column E and clearly brings out the year over year decline in the proportion in recent years. It indicates that banks allocated larger credit large business sector as compared to the small business sector. It seems the large business sector became more profitable from revenue perspective relative to small business sector and consequently banks allocated a larger share of credit to large businesses. It is also indicative of the relative riskiness of the small business sector. In the changing dynamics of the economy, especially in crisis years, banks were reticent to lend to small business.
- Column G: This column indicates the change in amount of credit outstanding (column B) year over year. It further confirms the above position. In 2004 and 2005, credit to small businesses expanded double digit. The lower growth in later years may mean that banks desired to curtail the already large exposure to small businesses achieved in earlier years.

New credit approvals to small business

Table 2 shows the new approvals of credit for small businesses.

Table 3
New credit approvals
($million)

A	B Small Business	C Large Business	D All Business	E Proportion SB to total B/D	F Change in proportion YoY	G Growth in credit approvals for Small Business YoY
Jun-2001	11915	28487	40402	29.49%		
Jun-2002	13751	31266	45017	30.55%	1.06%	15.41%
Jun-2003	14019	30929	44948	31.19%	0.64%	1.95%
Jun-2004	14070	40394	54464	25.83%	-5.36%	0.36%
Jun-2005	14909	37441	52350	28.48%	2.65%	5.96%
Jun-2006	16716	54622	71338	23.43%	-5.05%	12.12%
Jun-2007	22622	76515	99137	22.82%	-0.61%	35.33%
Jun-2008	22973	62435	85408	26.90%	4.08%	1.55%
Jun-2009	19061	45670	64730	29.45%	2.55%	-17.03%

(Source: Extracted from RBA statistical tables: Table 8 (col. A to D), other columns: author's calculations)

Following points emerge from the above data:

- Column E: New credit approvals for small business as a proportion of all business has shown increase since June 2007. The rising proportion could also indicate fewer uptakes by large businesses as they raised funds directly.
- Column F: The year over year change in the proportion also confirms the increases demand for new credit approvals.
- Column G: The sharp fall in new approvals in the year ending June 2009 and nearly stagnant new approvals in the year ending June 2008 is indicative of credit crunch faced by small businesses during the crisis years.

Credit is like oxygen for small businesses and credit crunch faced by small businesses especially at the time of the crisis when they needed it most would have severely affected their financial viability.

It is also important to know the break up credit outstanding and new credit approvals at lower loan sizes, for example, below $500K, between $500K and $ 1 million and between $ 1 million but below $2 million. Such statistics currently doesn't seem to get compiled. It may indicated difficulties faced within the small business group and enable appropriate strategic decisions to be made.

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

The state of competition in small business lending:

The following table shows the small business loans outstanding by type of lending institutions. The commercial loans of credit unions (CUs) and building societies (BS) have all been considered to be for small businesses.

Table 4

Small Business Loans outstanding

	Banks A	CU B	BS C	TOTAL D	A/D E
Mar-2005	151878	1040	771	153689	98.82%
Jun-2005	158431	1081	770	160282	98.85%
Sep-2005	159646	1130	819	161595	98.79%
Dec-2005	163349	1161	885	165395	98.76%
Mar-2006	167549	1203	877	169629	98.77%
Jun-2006	170805	1242	870	172917	98.78%
Sep-2006	171821	1164	904	173890	98.81%
Dec-2006	173183	1181	923	175286	98.80%
Mar-2007	178469	1178	977	180624	98.81%
Jun-2007	187076	1214	974	189264	98.84%
Sep-2007	189040	1216	1031	191287	98.83%
Dec-2007	189198	1196	1032	191426	98.84%
Mar-2008	196224	1210	1074	198509	98.85%
Jun-2008	199842	1240	1115	202197	98.84%
Sep-2008	203376	1190	886	205452	98.99%
Dec-2008	202718	1179	877	204773	99.00%
Mar-2009	197597	1176	872	199645	98.97%
Jun-2009	201111	1166	880	203158	98.99%
Sep-2009	200658	1186	880	202723	98.98%
Dec-2009	200531	1200	909	202639	98.96%

(Source: RBA Statistical Tables B7, B8 and D8)

As can be seen from Column E, banks are almost the sole providers of small business financing sector and particularly so during the crisis years and after. The data on small business loans of individual banks over the years would need to be compiled from annual reports of these banks and then index such as the HHI could be used to test the concentration. However, a proxy of share of major banks in total loans and advances shows heavy concentration of loans in major banks. The share of major banks is rising since June

2008 though earlier years showed a declining trend. Crisis has led to concentration of market power in the hands of the major banks. Merger of St George with Westpac and that of BankWest with Commonwealth also led to further concentration of market power in terms of deposits and loans & advances.

Table 5

Total loans advances outstanding

$million

		Jun 2004	Jun 2005	Jun 2006	Jun 2007	Jun 2008	Jun 2009	Sep 2009
Major	A	811,907	885,376	978,442	1,111,862	1,278,885	1,537,068	1,545,030
others	B	229,652	254,670	291,288	347,875	437,149	309,032	304,797
All banks	C	1,041,559	1,140,046	1,269,730	1,459,737	1,716,034	1,846,100	1,849,827
A/C	D	77.95%	77.66%	77.06%	76.17%	74.53%	83.26%	83.52%

(Source: APRA Statistical Tables no 2 and 5)

Amount in row B is computed by subtracting the amounts in row A from row C. The amounts in row A and C have been compiled from APRA statistical statements.

The impact of the Government's banking guarantees:

During the crisis due to the high cap on free guarantee, deposits flowed from the non-bank institutions to banks in particular the major banks (please refer to my submission dated 11 August 2009 to the Senate Inquiry on Bank Funding Guarantee). As banks become the sole warehouse of liquidity, businesses and households were at their mercy.

Banks cashed on the opportunity by increasing business lending rates, for example, the small business variable other (non-residential) overdraft rate. The pre-crisis lending rate was 9.7 per cent. It rose to 11.60% by July 2008 and continued to be double digit till December 2008. The rate now stands at 9.55 and is comparable to the pre-crisis levels.

However, a number that we need to watch is the spread between average borrowing cost the banks pay and average lending rate they receive. Higher spread is indicative of higher profits. The spread between interest paid on online savings account as above and the lending rate charged to small business indicated above, jumped from pre-crisis level of 3.80% to 5.55% by January 2009 and currently stands at 5.70 (source: RBA, 2010, Statistical Tables F4 and F5).

References

Bickerdyke, I., Lattimore, R and A. Madge (2000) *Business Failure and Change: An Australian Perspective,* Productivity Commission, Staff Research Paper, p. 50.

Reserve Bank of Australia and Australian Prudential Regulation Authority: various statistical statements.