Access for small & medium business to finance

Submission to the Corporations and Financial Services Committee
9 February 2011

Invigorating Business Representation

Executive Summary

The NSW Business Chamber welcomes the opportunity to make a submission regarding small business access to finance. The NSW Business Chamber represents the interests of around 30,000 companies across NSW and the ACT, ranging from owner-operators to corporations and from manufacturers to service providers.

The roughly 2 million small businesses in Australia make a very significant contribution to the Australian economy, representing over a third of total industry value added and almost half of all private sector employment. Access to finance is an issue of significant concern for many of these small businesses. The NSW Business Chamber's latest *Business Conditions Survey* found that 22 per cent of small business respondents said that ease of access to finance had deteriorated over the past three months, and only 3 per cent expected that conditions would improve over the next three months.

The global financial crisis has allowed the major banks to improve their market share and profitability at the expense of smaller banks and financial institutions, with many smaller players either being bought out by the big banks or exiting the market altogether.

The major banks have also shifted greater amounts of risk off their balance sheets through stricter lending requirements, such as higher levels of collateral. Net interest margins for the major banks are the highest they have been since 2004, and the last couple of years have seen profitability of the major banks increase relative to their regional counterparts.

This is not a healthy outcome for the small business sector – the deterioration in competition has reduced the accessibility of small business finance and increased the price at which finance is available. Spreads on small business loans have blown out from around 200 basis points to more than 400 basis points, and business credit has now fallen for 25 months. Tightening credit requirements, and an apparent overreaction towards risk aversion by the major banks continue to constrain the availability of credit. Given the contribution small businesses make to the national economy, this is an issue of significant concern.

In the absence of comprehensive data on bank lending, anecdotal evidence from small businesses provides an important indicator of current trends in small business access to finance. Such analysis reveals a range of instances of banks tightening lending criteria and undermining the viability of otherwise profitable small businesses.

While recognising that the banks need to run their businesses in a responsible fashion to minimise the risks they are exposed to, the significant tightening of lending criteria has threatened the ongoing viability of many small businesses. In situations where businesses remain profitable and sustainable, changes in lending requirements have undermined the feasibility of existing business plans and required small businesses to alter their strategy, resulting in them curtailing plans for expansion, downsizing, or in some cases exiting the market altogether.

Restoring competition is essential to improve conditions for small business lending, but reforms in this area will take time to flow through the sector. Short-term support is needed to improve conditions in small business lending until competition returns to the market.

That is why the NSW Business Chamber supports the introduction of a temporary guarantee of small business loans.

Recommendation 1: That the Government consider the implementation of a guarantee of small business loans in Australia, taking into consideration the principles outlined below.

The implementation of an appropriately priced government guarantee is an effective way of rejuvenating the flow of finance to productive parts of the economy and can be self-funded. The fact the such a program could be implemented in a timely fashion, and the temporary nature of the support provided are key advantages of this idea.

In order to ensure that such a scheme operated effectively, there are some principles that should be followed:

- **There needs to be a price charged for the guarantee.** Charging a price protects the Government's financial position, and ensures that it is appropriately compensated for the risk transferred to its balance sheet. Providing a price signal also means that use of the guarantee should naturally wind down over time as market conditions return to more normal levels over the medium-term.

- **Banks should remain responsible for the financial assessment of small business applicants.** Bank assessment of the loans will ensure that applications still have to meet minimum standards in order to be eligible for the guarantee. In this way, the risk of defaults, and the Government guarantee being utilised, are minimised.
- **The guarantee should not cover 100 per cent of the loan.** In order to avoid moral hazard issues, it is important that banks still have a financial incentive to carefully consider loan applications. Similar guarantees in other countries tend to cover between 75 and 85 per cent of the loan.
- **The guarantee should not be capped, and should be available to the entire small business sector.** While the scheme would only be eligible to individual loans below a certain threshold, for the scheme to be effective and to avoid rationing of finance, it is important that the total amount the Government is willing to guarantee is uncapped.

We have also put forward several other recommendations to support the restoration of competition in the banking sector.

Recommendation 2: That the Government continue to direct the AOFM to invest in Residential Mortgage Backed Securities until conditions in this market have normalised.

The Government support to date is welcomed, but it may need to be extended given that conditions remain challenging. Giving greater focus to support for small business lending through this initiative is also encouraged.

Recommendation 3: That the Government put greater pressure on banks to keep small business lending rates down, and publicise good and poor performance in this area by individual banks.

While Governments are quick to name and shame those banks that increase interest rates outside the RBA cycle, or fail to pass on cuts in full, they have been far less vocal when it comes to the circumstances of small business loans. The Government should draw as much public attention to small business lending conditions as it does to conditions for household mortgage holders.

Recommendation 4: That the Government remain open to new market entrants, both domestic and foreign, as a means of reinvigorating competition within this sector.

New market entrants provide an essential source of competition, which would help to place downward pressure on the margins currently being enjoyed by the major banks.

Recommendation 5: That further mergers between significant players in the banking sector not be allowed until competition has been restored. Subsequent mergers within the banking sector should be considered very carefully, with a particular focus on their potential impact on competition.

The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further consolidation of market power within the major banks should not be allowed in the current environment.

Recommendation 6: That the Productivity Commission complete a review looking at the degree of competition in the provision of business finance.

An open Productivity Commission review of the costs and constraints faced by small businesses in attracting finance could give this issue greater prominence, and assist in promoting competitive pressures within this part of the banking sector.

The Importance of Small Business Finance

Small businesses (defined by the ABS as those employing less than 20 people[1]), make a very significant contribution to the Australian economy. As at June 2009, there were approximately 1.96 million active small businesses in Australia, representing around 96 per cent of all Australian businesses.[2] Small businesses make a significant contribution to employment, with over 730,000[3] small businesses employing 4.8 million[4] people at the end of June 2009; almost half of all private sector employment, (10.0 million at June 2009).

Small businesses contributed over $290 billion to industry value added in 2008-09, representing over a third of total industry value added ($843 billion in 2008-09).[5] Approximately 16,500 small businesses exported goods in 2008-09, representing 38 per cent of all exporters.[6]

Given the significant contribution that small businesses make to the Australian economy, it is important that the Government is proactive in ensuring that the business environment does not impede the ability of these small businesses to operate and grow.

Victoria University's access to finance survey

Victoria University, in collaboration with the State Chambers and ACCI, recently completed a survey looking at business issues around access to finance. The survey was conducted between June 2010 and January 2011, and surveyed a total of 953 businesses from New South Wales, Victoria, Western Australia, Tasmania and South Australia.

This submission draws extensively on the quantitative findings from this survey, as well as the anecdotal evidence provided through comments from individual respondents.

Importance of the issue

> *"Our clients find real business lending from banks to be hard. Banks want to lend on a proprietor's house title. That is not really business lending. The lack of easy funding opportunities is/will restrict growth of small business in Australia." – respondent to Victoria University's access to finance survey.*

Access to finance is an issue of significant concern to small businesses. The NSW Business Chamber conducts a quarterly Business Conditions Survey which, among other things, gathers data from businesses on access to finance. The latest survey (November 2010), found that 22 per cent of small business respondents said that ease of access to finance had deteriorated over the past three months, and less than 3 per cent expected that conditions would improve over the next quarter.

Victoria University's survey found that access to finance was a critical issue for small businesses. Respondents identified inadequate access to finance as a significant barrier to growth, second only to recruiting and retaining skilled labour.

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[1] Australian Bureau of Statistics, *1321.0 Small Business in Australia,* 2001, p. 1.

[2] Australian Bureau of Statistics, *8165.0 Counts of Australian Businesses,* October 2010, Table 13.

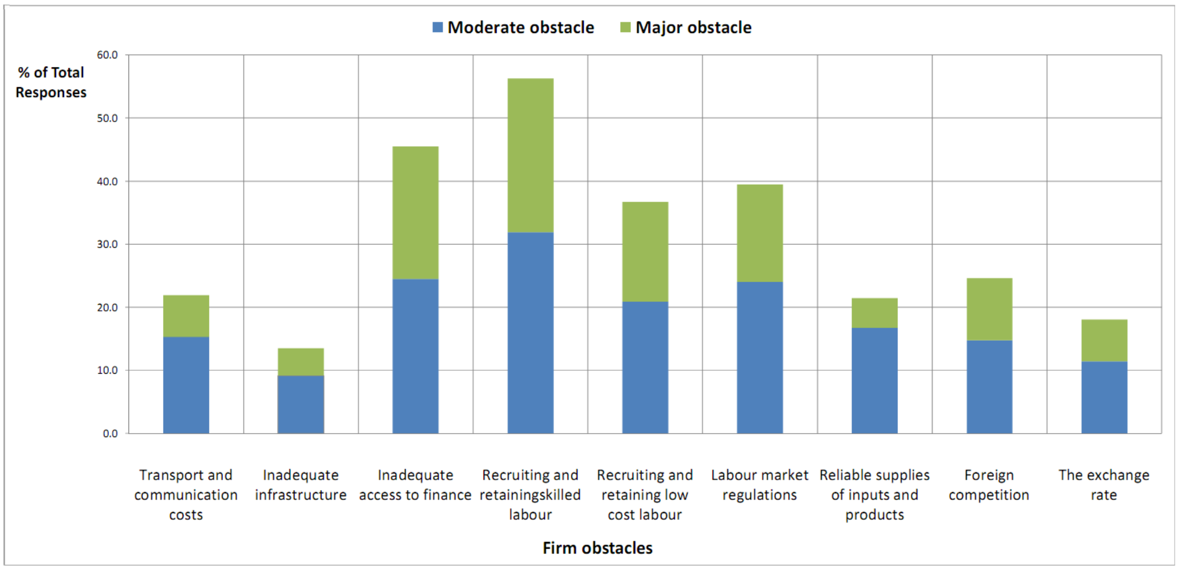
[3] ibid.

[4] Australian Bureau of Statistics, *8155.0 Australian Industry,* 2008-09, Table 2.1

[5] ibid.

[6] Australian Bureau of Statistics, *5368.0.55.006 Characteristics of Australian Exporters,* 2008-09, Table 5

Chart 1 – Small business barriers to growth



In addition, 37.5% of small businesses said they need access to external finance to survive the next 12 months, and 63.4% of small businesses agreed that access to finance was essential for the business to achieve its long term goals.

Interestingly, the survey also found that firms with the greatest desire to grow are also the ones most likely to be financially constrained. Only 20.4% of businesses where growth is not a priority find access to finance to be an obstacle. In contrast, access to finance is an obstacle to growth for 59.7% of businesses where growth is the most important priority.

A recent survey conducted by the Council of Small Business of Australia (COSBOA),[7] found that 81 per cent of small businesses were concerned about higher interest rates, 74 per cent were concerned about the cost of finance and 64 per cent were concerned about the availability of finance. When asked to list their single biggest concern, nearly half of all respondents identified finance related issues (either the costs of finance, access to finance or interest rates).

Small businesses will struggle to grow without access to finance. Their lower margins and smaller size means that it is more difficult for them to save; and funding expansions, riding economic downturns, and maintaining the ongoing viability of a small business typically all require access to finance.

The Australian economy is currently performing strongly relative to the rest of the developed world, and there is a real opportunity for Australian businesses to capitalise on the current conditions. However, without access to finance, small businesses will be unable to take advantage of the opportunities they identify.

The Victoria University survey identified small businesses that had been unsuccessful in accessing external finance in the past two years on at least one occasion. Of these small businesses, 86.0% agreed that being turned down had constrained firm growth significantly, and 42.1% agreed that it had increased the chances of bankruptcy significantly.

Our submission makes several recommendations which aim to improve the level of competition in the banking sector, and it is hoped that, over time, increased competition will improve conditions in small business lending. However, access to finance is a critical issue for small businesses now, and the experience of the past few years has demonstrated that it will take a long time for effective competition to return to the market, even if the government takes proactive steps to encourage this outcome. For this reason, we believe it is necessary for temporary measures to be introduced to support small business lending until such time as other policies are able to return competition to the market.

[7] COSBOA, Telstra, *Back to Business Survey*, 2010, p. 7.

A guarantee of small business loans

We believe that a guarantee of small business loans would provide effective support to small business lenders until sufficient levels of competition have returned to the market.

Other countries have introduced guarantees on small business loans to assist with alleviating small business credit constraints:

- 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.[8]
- Under **Canada's** small business financing program, the Canadian government guarantees 85 per cent of eligible small business loans. The guarantee is provided to the small business in exchange for a fee, and in this way, the scheme is self financing.[9]
- In the **United States,** the Small Business Administration (SBA) guarantees loans made to small businesses by financial institutions.[10]

Each of these schemes is different, and has been structured to address the specific difficulties faced by small businesses in each country. However, the programs all recognise that there is a valid role for Government to play in assisting small businesses to access the finance they need to operate and grow. Given the ongoing constraints that small businesses are facing in accessing finance, there is scope for the Government to give consideration to establishing a similar scheme in Australia.

Such a scheme can support small business lending by allowing the banks to extend finance to businesses which they would otherwise consider to be too high risk. It may also allow banks to provide higher levels of finance to individual borrowers than would otherwise be the case. In effect, the guarantee can bridge the gap where a small business is unable to provide sufficient collateral to support a loan.

As the small business is charged for the guarantee, businesses will only use it where they would otherwise be unable to secure finance. In this way, it should be possible to demonstrate the degree to which the guarantee increases aggregate levels of lending to small businesses.

In order to ensure that such a scheme operated effectively, there are some key principles that should be followed:

There needs to be a price charged for the guarantee. This approach is consistent with the approach taken by the Government in implementing the wholesale funding guarantee and the guarantee of State and Territory borrowing. Having a price signal on the guarantee is important for a number of reasons.

Charging a price for the loan protects the Government's financial position, and ensures that it is appropriately compensated for the risk transferred to its balance sheet. However, guaranteeing small business loans presents different risk characteristics to a guarantee of State borrowing or wholesale funding. Wholesale funding and State borrowing guarantees cover a relatively small number of very large loans, and while the probably of any individual default is very low, the financial consequences for the Government of any individual default are very high. In contrast, a guarantee of small business loans would cover a large number of loans which individually are relatively small. While the probability of individual loans failing is higher, the financial consequences for the Government of any individual failure are minor.

Setting an appropriate price for the Government guarantee would ensure that the cost to the Government of calls on the guarantee was offset by the fee revenue collected. Such an approach would be similar to the cost recovery model adopted in the case of the Canadian scheme.

Charging a price for the guarantee also means that use of the guarantee should naturally wind down over time as market conditions return to more normal levels over the medium-term. As banks' pricing of small business risk and willingness to lend to small businesses gradually returns to more normal levels over time, the incentive for small businesses to use the guarantee will be reduced. As economic conditions change, the market will naturally wean itself off the guarantee, removing the need to include an explicit sunset clause with the scheme.

[8] Department for Business Innovation and Skills, http://www.berr.gov.uk

[9] Industry Canada, http://www.ic.gc.ca

[10] US Small Business Administration, http://www.sba.gov

Banks should remain responsible for the financial assessment of small business applicants. The Government does not have the expertise to assess small business loan applications. Banks and other financial institutions are the organisations best placed to assess the merits of loan applications. Leaving responsibility for loan assessments with the banks also allows the scheme to be implemented in a timely fashion.

Bank assessments of the loans will ensure that applications still have to meet minimum standards in order to be eligible for the guarantee. In this way, the risk of defaults, and the Government guarantee being utilised, are minimised.

The guarantee should not cover 100 per cent of the loan. This idea follows on from the principle that banks should be responsible for the financial assessment. In order to avoid moral hazard issues, it is important that banks still have a financial incentive to carefully consider loan applications. Not guaranteeing the loan in its entirety provides the banks with this incentive.

Similar guarantees in other countries tend to cover between 75 and 85 per cent of the loan. The proportion of the loan guaranteed needs to be high enough that banks are encouraged to loosen their lending constraints, while being low enough that the banks still have an incentive to carefully assess each application.

The guarantee should not be capped, and should be available to the entire small business sector. While the scheme would only be eligible to individual loans below a certain threshold, for the scheme to be effective and to avoid rationing of finance, it is important that the total amount the Government is willing to guarantee is uncapped.

Recommendation 1: That the Government consider the implementation of a guarantee of small business loans in Australia, taking into consideration the principles outlined above.

Market Conditions

The global financial crisis had a dramatic impact on financial institutions around the world. While the worst of the crisis has passed, growth remains subdued, particularly in Europe and the United States, and banks in these countries continue to experience difficulties. With foreclosures continuing to depress markets in the US, and the Ireland Government recently accepting a bailout from the EU to support its main banks, it appears likely that the banking sectors in these regions will remain under pressure for some time.

While not immune from the impacts of the global downturn, the Australian economy and banking sector have proved to be more resilient. A combination of accommodative monetary policy, flexible labour markets and fiscal stimulus helped to cushion Australia from the worst of the crisis.

The stability of the domestic economy lessened the impact of the global downturn on Australian banks, however, conditions in the sector were far from rosy over this period. Many smaller lenders were unable to source funding at competitive rates and were squeezed out of the market, and many international banks downsized or withdrew from the Australian market. Mergers between some of the larger banks were allowed to support their ongoing viability, and the Government provided guarantees of wholesale funding and deposits to shore up confidence in the sector.

While resilient overall, the Australian banking sector that has emerged from the GFC looks quite different to its pre-GFC incarnation. Consolidation within the sector has seen the four major banks take an increasing share of the overall market, at the expense of smaller players:

- The number of competitors and range of products offered within the industry has been reduced. In October 2007, the Australian mortgage market was serviced by over 150 financial institutions offering over 2,117 home loan products.[11] In November 2010, this had fallen to 100 financial institutions offering 1,600 products.[12]
- The larger banks have increased their market share, largely at the expense of non-bank lenders. In new home loan lending, banks held a steady market share of 80% over most of the decade, but coinciding with the subprime crisis in the second half of 2007, this jumped to 90% in the space of less than a year, and has remained stable around this level ever since.[13] This increased market share has come almost exclusively at the expense of wholesale lenders, who were no longer able to raise funds at competitive prices.

The increased market share experienced by the major banks, coupled with the difficulties smaller player were having sourcing finance, has meant that the major banks have been able to sustain their profitability at levels higher than may have otherwise been the case. Net interest margins and returns on equity at the major banks have both been sustained at healthy levels in recent years.

Prior to the global financial crisis, competition between the banks and non-bank lenders was proving effective in driving down net interest margins. Between 1999 and 2008, net interest margins fell from nearly 3.5 per cent to below 2.25 per cent.

However, net interest margins began increasing late in 2008, and continued to do so throughout 2009, at the same time that the Government was providing substantial guarantees to the banking sector. By early 2010, the net interest margins of the major banks were around 2.5 per cent, a level not seen since early 2004.

In contrast, net interest margins in the regional banks continued to fall, and were running at around 1.5 per cent at the end of 2009.[14] The major banks were able to consolidate their financial position over this period, with a significant widening of the gap in net interest margins between themselves and the regional banks.

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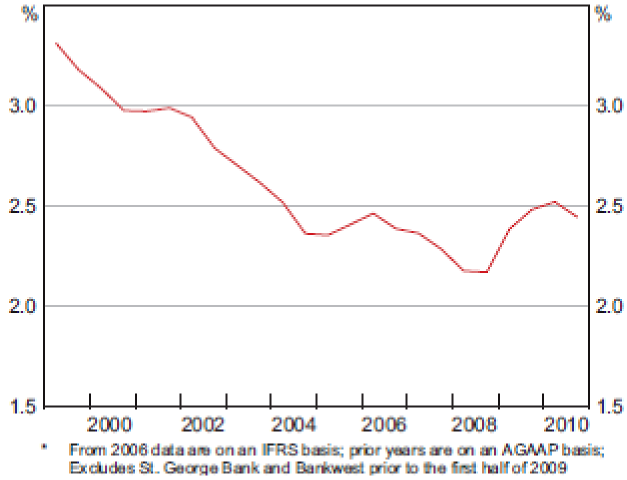
11 CANSTAR CANNEX, *Mortgage Star Ratings, Report No 20,* October 2007.

12 CANSTAR CANNEX, *Mortgage Star Ratings, Report No 24,* November 2010.

13 Australian Bureau of Statistics, *5671.0 – Lending Finance, Australia,* November 2010.

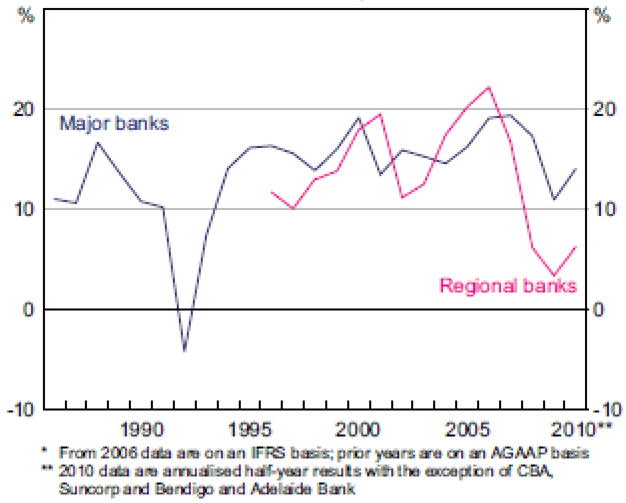
14 Reserve Bank of Australia, *Bulletin – Recent Developments in Banks' Funding Costs and Lending Rates,* March 2010, p. 43.

Chart 2 – Major Banks' Net Interest Margin* (half-yearly)[15]



While the global financial crisis had a dramatic impact on the banking sector in other countries, in Australia the major banks were able to maintain a return on equity of above 10 per cent. While the return on equity exhibited by the major banks and regional banks had been fairly similar over most of the decade, the major banks have shown a much greater capacity to sustain their return on equity since the global financial crisis.

Chart 3 – Return on Equity* (post tax and minority interest)[16]



Given these differences, it is not surprising that the major banks have been more profitable than their competitors during and following the downturn. Over the twelve months to 30 June 2010, the four major banks operated at a profit margin of 25.2 per cent, while the remaining domestic banks had a profit margin of 11.9 per cent.[17]

The experience of the last twelve months has demonstrated that competition has been very slow returning to the market, and that businesses will continue to struggle as the major banks exercise their marker power.

15 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 42.

16 Reserve Bank of Australia, *Financial Stability Review*, September 2010, p. 21.

17 APRA, *Quarterly Bank Performance Statistics*, June 2010, p. 5.

The RMBS market

Many smaller lenders and non-bank lenders rely heavily on RMBS issuance as a source of funding. Issuance increased strongly over the first half of the last decade, from less than $20 billion in 2000 to around $55 billion in 2006.[18] When the sub-prime crisis hit the US in the middle of 2007, domestic RMBS conditions tightened dramatically. The spreads on RMBS issuance increased to the point where new issuance was no longer economic for the smaller lenders and wholesale lenders. The result was that many of these lenders lost a critical source of funding and had to significantly curtail their lending activities.

We welcomed the decision of the Federal Government to direct the Australian Office of Financial Management (AOFM) to purchase RMBS as a way of supporting the market. Without this support, the appetite for RMBS would have remained at virtually zero. As at 15 September 2010, the AOFM had purchased $11 billion of RMBS, and had supported issuance of a further $12.1 billion.[19] We also welcomed the Government's December 2010 decision to introduce a third tranche of support for the RMBS market, setting aside a further $4 billion for this purpose.[20]

While the support from the Federal Government has been of assistance to RMBS issuers, the RBA notes that "conditions in RMBS markets ... are still challenging."[21] Even with the support of the AOFM, RMBS issuance is much lower now than it was prior to the financial crisis, with issuance in 2008 and 2009 of around $10 billion and $15 billion respectively.[22]

On current prices it appears that excessive risk aversion remains about investment in this market. The spreads on new RMBS issuance remain at around 140 basis points over swap,[23] well above levels it was trading at prior to the crisis. This is in spite of the fact that the assets are AAA rated and that "no losses have be borne by investors in a rated tranche of an Australian prime RMBS."[24]

A well functioning RMBS market is essential to provide smaller lenders with an affordable source of funding which allows them to compete with the big banks. We believe that the AOFM should continue to purchase new issuance of RMBS until the market returns to more normal levels. This may require the Government to commit more than the $20 billion that has already been set aside for investments of this kind. However, the fact that the assets purchased by the AOFM are AAA rated means that there is very little risk to the Government's balance sheet. Since the interest earned on these investments is higher than the Government's cost of funds, these investments actually improve the Government's fiscal position.

While the initial policy objective was to support residential lending, we note that the Treasurer's Direction of 30 November 2009 included the additional policy objective to "provide support for lending to small business, through participating lenders using some of the proceeds of the AOFM's investment for lending to small business."[25]

While this was an encouraging development, it is unclear what proportion of the AOFM's purchases has supported residential lending and what proportion has supported small business lending. A more explicit Direction which required a minimum proportion of the AOFM's investment to support small business loans would be welcomed.

Recommendation 2: That the Government continue to direct the AOFM to invest in Residential Mortgage Backed Securities until conditions in this market have normalised.

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[18] Reserve Bank of Australia, *Financial Stability Review*, March 2010, p. 28.

[19] Australian Office of Financial Management, *RMBS Investor Program – Investor Update,* September 2010, slide 15.

[20] Federal Treasury, *Competitive and Sustainable Banking System,* December 2010, p. 19.

[21] Reserve Bank of Australia, *Financial Stability Review,* September 2010, p. 26.

[22] Reserve Bank of Australia, *Financial Stability Review,* March 2010, p. 28.

[23] Reserve Bank of Australia, *Financial Stability Review,* September 2010, p. 27.

[24] ibid.

[25] The Hon. Wayne Swan, *Direction on Investment in RMBS,* 30 November 2009, p. 1.

Trends in small business lending

Risk aversion during the GFC saw small business lending conditions tighten significantly, both in terms of tightening lending criteria and relative costs of funds. As such, it is unsurprising that overall levels of credit growth fell significantly over this period.

However, with the worst of the crisis now behind us, lending conditions should have improved, and small businesses should now be able to access the funding they need to expand and support the economic recovery. Unfortunately, it appears that banks are reluctant to move away from the high levels of risk aversion adopted during the height of the crisis, and consequently small businesses continue to suffer. The reduction in competition in the banking sector has been partly responsible for this, and has made it easier for the banks to shift greater amounts of risk off their balance sheets through stricter lending requirements.

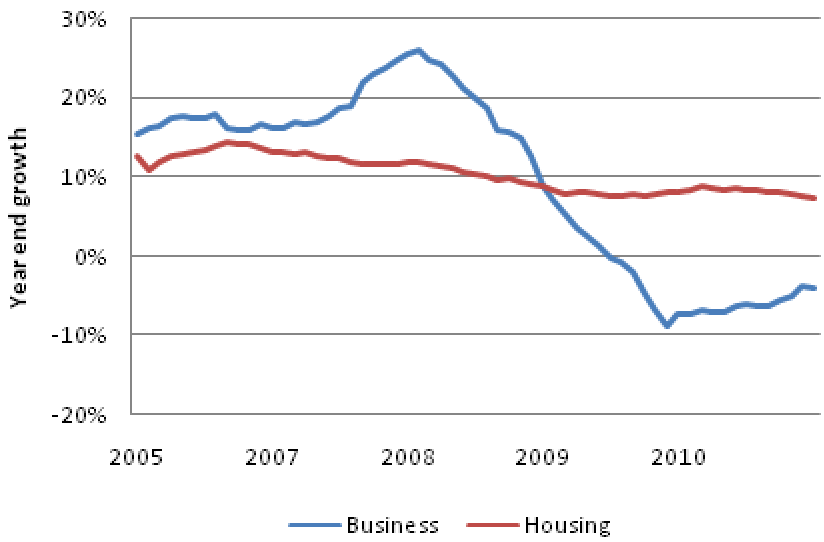
While recognising that the banks need to run their businesses in a responsible fashion to minimise their risk exposure, the significant tightening of lending criteria has threatened the ongoing viability of many small businesses. In situations where businesses remain profitable and sustainable, changes in lending requirements have undermined the feasibility of existing business plans and required small businesses to alter their strategy, resulting in them curtailing plans for expansion or in some cases exiting the market altogether.

Levels of finance

> *"It would help us to have additional finance in order to grow and to invest in new machinery. At present we cannot get this because the bank will not lend on the basis of the business as a going concern." – respondent to Victoria University's access to finance survey.*

The rate of growth in business lending fell throughout 2008 and 2009. Following an extended period of sustained growth through most of the decade, business credit has now fallen for a period of 25 months. The reduction in business credit has been far more dramatic than the reduction in housing credit, which has remained fairly stable over the same period, and has not fallen below an annual growth rate of 7 per cent.

Chart 4 – Credit growth[26]



[26] Reserve Bank of Australia, *Statistical Table D02 – Lending and Credit Aggregates*

It is impossible to say with certainty whether the decrease in business credit has been primarily due to businesses deleveraging and seeking alternative sources of finance, or excessive risk aversion on the part of banks curtailing business access to finance. However, the findings from the Victoria University survey suggest that tightness in supply is a key contributor. 40.3% of small businesses said that in the last two years they had passed up attractive business opportunities because they could not access external finance. Interestingly, businesses identified access to finance as a more important barrier than the cost of finance:

- 24.7% could not access finance because lending conditions (such as collateral requirements) were too strict;
- 8.8% said that finance was not available in sufficient quantity; and
- 12.5% said that the finance was too expensive (interest rates).

While banks have increased lending through mortgages, lending to businesses, and small businesses in particular, appears to remain stagnant, with limited competition between the banks to increase their market share in this area.

Tightening lending criteria

> *"If you have equity in your house you can get finance - if not good luck!" – respondent to Victoria University's access to finance survey.*

In the absence of comprehensive data on bank lending, anecdotal evidence from small businesses provides an important indication of current trends in small business access to finance. Such analysis reveals a range of instances of banks tightening lending criteria and undermining the viability of otherwise profitable small businesses, and indicates that, generally speaking, the banks appear to be unwilling to lend without very high levels of cash flow and security.

The Victoria University survey found that access to finance has been a significant issue for small businesses since the GFC. Around a third (34.5%) of small businesses have sought external finance in the past two years to fund business expansion. A further 18.7% would have sought finance for expansion, but did not do so because they believed their application would be unsuccessful.

Of those that had applied for finance to fund business expansion, 48.7% had been unsuccessful on at least one occasion, and 18.6% had been completely unsuccessful in all attempts.

The most common reason given by the lender for refusing an application was insufficient collateral (42.9%), followed by the lender believing the business was too indebted (32.2%). Of those who had failed to secure finance, 29.0% had a relationship with the lender which was more than ten years old.

The following selection of quotes from survey respondents highlights the difficulties currently being faced in accessing finance, and the tightening of lending criteria currently being applied by the banks:

> *"Banks will lend any amount of money to an individual who has home equity, but nothing for a business until the business no longer needs the money. This business has grown significantly, but could have grown bigger and faster with working capital instead of funding growth just from turnover."*

> *"[The bank] requires security in the form of tangible assets. Our tangible assets are all machinery which the bank doesn't want - they seem to only want land or property."*

> *"Because of the recent GFC, it seems that small business is having greater difficulty in obtaining finance. Most financial institutions are requesting a caveat over property, although the property is not owned by the business."*

> *"Banks won't lend money to small business even if that debt can be covered with assets. I wanted to expand the business but cannot get finance from the bank. They will give additional credit cards to use for funding, (very expensive credit) but not a loan or overdraft."*

> *"Our dilemma began in January 2009 when the GFC caused the partial withdrawal of promised funding for a business purchase approved late December 2008. We were left to complete the transaction using our operating capital, leaving us struggling ever since. We were unable to realise the benefits which had been identified during due diligence process, and we find ourselves locked in a financial vice."*

"To gain access to finance small business must borrow and have the assets – ie personal house to use as collateral. Small business then has to guarantee or indemnify the company structure. This is wrong."

"The Banks are not interested in you if you have no security. The only success I have had is with getting a credit card facility for the business. The local banker was instrumental in getting the card however credit cards do not help cash flow, and an actual business loan consolidating all my private debts would be a more appropriate product however banks aren't interested in doing that."

"In the past a customer of ours could borrow $500,000 to $1 million without the lender requiring 'bricks and mortar' security. The loan would be secured against the value of the equipment purchased, or perhaps a good contract the purchaser had signed, and he needed the equipment to carry out the contract. Perhaps the borrower would have to make a down payment of 10-15% at the most and the rest would have been financed. Today, basically nobody can obtain finance for capital equipment without providing 100% 'bricks and mortar' security for the loan."

"The only way we seem to be able to raise finance is to use credit cards or extend the mortgage on our home. We can only get $10,000 that way and fees are prohibitive at over $1,000."

"[We] have had to sell 45% of our business to an equity partner because of lack of funding options for our business. We had no problem in selling our share of our business because it has a steady rate of return on investment with very little risk. We, as we write these comments, are in the middle of a bank changeover but are using considerable home equity to secure more overdraft operating capital to grow our business. Unfortunately, we have had to take these measures in order to fill our new business demand. We would rather have not sold a share and used more funding options if the banks were not so shy in lending. Our business was more successful in raising equipment funding in its infancy before the GFC than it has been in recent times even though our turnover has grown 5 fold inside 3 years."

"For small amounts of finance, the bank fees are too high - establishment fees, etc. They also ask for unlimited personal guarantees and ridiculous amounts of collateral for quite small amounts of money."

It is common for small businesses to need to use personal assets to secure business finance, and the Victoria University survey found that 58.2% of small businesses had done so.

The Reserve Bank acknowledged that lending criteria tightened following the global financial crisis, and stated that:

"On the supply side, banks have also tightened the terms and conditions under which they are willing to extend credit to businesses and households. This contrasts with the easing in standards seen in earlier years, and reflects the banking sector's response to a perceived increase in the probability of default among most categories of borrowers. As these risks have risen, banks have sought to conserve capital by directing their lending towards less risky ventures. Over the past couple of years, banks have generally also raised risk margins and strengthened non-price loan conditions, such as collateral requirements and loan covenants."[27]

While it was not surprising that access to finance would be difficult during the global financial crisis, it is concerning that conditions remain so challenging so long after the worst of the crisis appears to have passed. As the last of the government's fiscal stimulus is withdrawn, it is important that a private sector recovery takes hold if growth is to continue. With businesses continuing to struggle to access finance, growth prospects for the Australian economy will be more limited.

Treating each case on its merits

"We have found that a good credit and trading history with the banks has very little importance. They seem to only look at the dollars requested verses security/equity offered, and measure this against their standard guidelines, regardless of solid history. Take it or leave it." – respondent to Victoria University's access to finance survey.

There is a clear impression within the small business community that banks are no longer assessing individual applications for funding on their merits. Standardised and inflexible criteria applied in a simple "tick/cross" fashion are meaning that many businesses with sustainable business cases are finding themselves unable to source funding.

[27] Reserve Bank of Australia, *Financial Stability Review*, September 2009, p.29.

Part of this generalisation in processing applications appears to have derived from the centralisation of bank decision making. One respondent to the Victoria University survey noted:

> *"We've found dealing with the major financial institutions to be tough, as we don't appear to fit their loan profile. Having said this we have been quite conservative in our approach – in years gone by we had regular contact with a Bank manager, who incrementally got to know our business, and over the years provided some flexibility and support. The bank/s then appeared to withdraw their ability to make these decisions locally and we had to deal with "head-office" which became almost a waste of time – meeting and negotiating with recently qualified number crunchers, years our junior and who had (clearly) never been in private employ and responsible for staff and the operational success of a business. The GFC of course has cut our cash flow dramatically, and the banks have responded even more conservatively. Their advertising of being "with you through the highs and lows," we feel has been merely advertising rhetoric!"*

Other survey respondents highlighted similar concerns:

> *"We have found that banks change their managers regularly and are not a useful source of assistance to a small business as we have never been able to build a useful relationship. I suspect we do not pay them enough fees which may explain their lack of interest. Bankers only want to know us when we have lots of money but if things are tough they do not want to know you."*

> *"We feel that we have no room for negotiation to obtain better deals. Impression is a "take it as is or leave it" attitude with our financiers."*

> *"The Commonwealth Bank has actually asked for more security, yet debt has more than halved and all payments made on time. Whilst the company is profitable, did not achieve one of the covenants, hence the requirement, yet we only now owe 25% of the original amount borrowed 3 years ago."*

> *"We have a personal loan/line of credit against our house which is half the available loan we could have. We now need a small amount extra for the next 2-6 months, but ANZ will not extend the loan because it is too business related in their eyes – but that is how the loan was at the beginning. The parameters for a yes or no change constantly and this is very frustrating."*

> *"[The banks] are being less flexible in considering alternatives that once were quite acceptable to them. Ours is a highly profitable low risk business but they are treating us more like a risky start-up enterprise."*

Failure to properly consider the specific merits of individual applications will mean that viable business models are unable to secure financing. Decision making needs to be personalised, not generic, to ensure that sustainable businesses are able to secure the financing they need to grow and prosper.

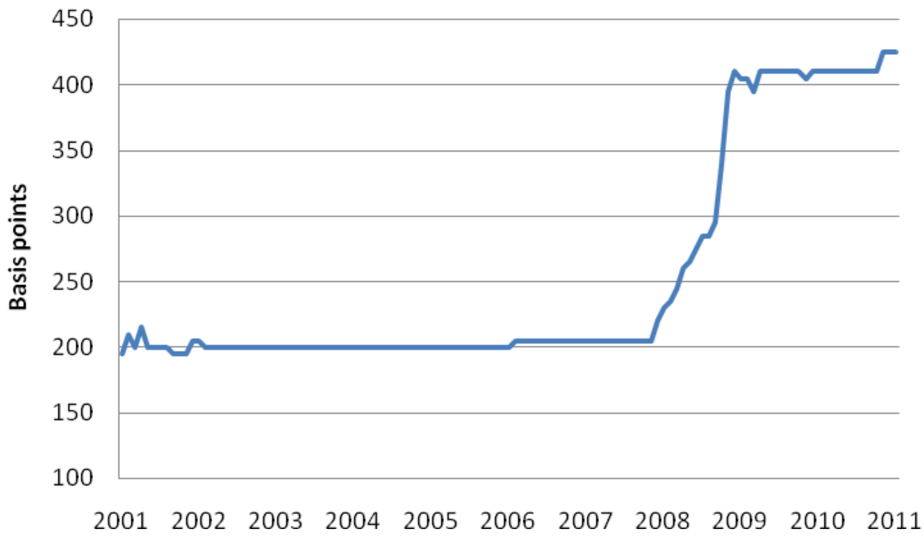
Small business interest rates

> *"The bank's lending margin has spread too much. A loan from two years ago had a margin of 0.5% as a line fee, now it's 2.5%." – comment from respondents to Victoria University's access to finance survey.*

Over recent years, the cost of funds for small businesses has increased significantly. Prior to the global financial crisis, the spread between small business interest rates and the cash rate was around 200 basis points, but the spread has since doubled to more than 400 basis points, with a significant spike following the collapse of Lehman Brothers in the second half of 2008.

While credit conditions have stabilised somewhat since then, the spread on small business loans has remained at around 400 basis points since November 2008, and in fact has increased further to 425 basis points following the Reserve Bank's decision to increase interest rates last November.

Chart 5 – Spread between small business loans and the cash rate[28]



In contrast, spreads on mortgages have remained more stable over this period, and there have been signs among the banks of greater competition in this area. Prior to the global financial crisis, the spread between residentially backed small business loans and home loans was around 65 basis points.[29] This was in recognition of the fact that residentially backs small business loans are a slightly riskier financial product for the banks than home loans.

In giving evidence to the Senate Inquiry into Small Business Access to Finance in April 2010, Mr Ian Narev from the Commonwealth Bank drew attention to the fact that the difference between their home loan and residential secured business loan was 50 basis points. Mr Narev stated that the higher price was set by using "a statistical model that analyses 20-plus years of history and the difference in the probability of default for a business loan versus a home loan..."[30] Given the similarities in the home loan and small business loan portfolios of each of the major banks, it would be expected that the risk premium charged by each of the major banks would be similar.

Instead, the spreads between each of the four major banks are quite different, with the latest Cannstar Cannex data showing the spreads charged by each of the banks ranged from a low of 49 basis points to a high of 171 basis points.[31] This suggests that the banks are using quite different models to calculate the probability of default, or that perhaps some banks are building some fat into their risk premium.

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[28] Reserve Bank of Australia, *Statistical Table F5 – Indicator Lending Rates*

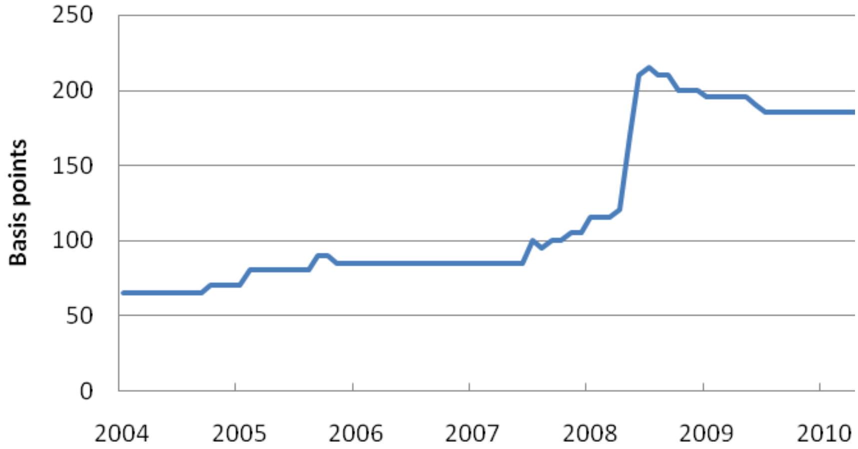
[29] The home loan rate used for this comparison is the discounted variable rate.

[30] Senate Economics References Committee, *Hansard – Access of small business to finance*, 12 April 2010, p. E102.

[31] The home loan rate used for this comparison is the standard variable rate.

Overall, the spread between home loans and business loans has increased from around 65 basis points prior to the global financial crisis, to 185 basis points in October 2010, an almost three-fold increase.

Chart 6 – Spread between business loans and home loans[32]



Small businesses are concerned about the increased margin between small business loans and home loans, and respondents to the Victoria University survey commented on this issue:

> *"I have been very disappointed that in the last two years the bank has increased the gap in finance costs by 1.01% on the commercial loan as compared to the residential loan. There has been no other change in the financing arrangements over this time to justify this managing of the variable rate over this period. I have reduced debt by $80,000 (combined loans) over the same period which should show the bank we are good customers."*

> *"The most scandalous aspect of business banking loans from the "Big 4" to SME's is the cost of finance. The "premium" charged for residential property-backed business loans over residential home loans is a rort and completely unjustified."*

While politicians have been quick to criticise the banks for increasing mortgage rates beyond movements by the Reserve Bank, they have been far more reluctant to do so in relation to movements in small business interest rates. This was most recently demonstrated following the Reserve Bank's decision to lift the cash rate by 25 basis points on Melbourne Cup day, and the subsequent decisions of the four major banks to increase their mortgage rates by significantly more than this amount. Politicians were quick to criticise these mortgage rate increases:

> *"I think there's a culture of arrogance among the banks" and "This behaviour, I think, is arrogant, in the extreme..." – Wayne Swan, Interview with Lyndal Curtis, 3 November.*

> *"I think the Commonwealth Bank deserves the savage reaction that it's experienced" – Wayne Swan, doorstop interview, 3 November.*

> *"...there is no excuse for the sorts of interest rate movements we've now seen from the Commonwealth Bank and the ANZ Bank." – Julia Gillard, Press Conference in Seoul, 10 November 2010.*

Following their decisions to increase mortgage rates by more than the increase in the cash rate, the major banks subsequently passed on similarly large increases in small business interest rates, The Commonwealth Bank increased its small business interest rate by 44 basis points, NAB increased their rate by 43 basis points, while ANZ and Westpac passed on 39 and 35 basis points respectively.[33] Despite this, there appears to have been no public condemnation of this action by any politicians.

Recommendation 3: That the Government put greater pressure on banks to keep small business lending rates down, and publicise good and poor performance in this area by individual banks.

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[32] Reserve Bank of Australia, *Statistical Table F5 – Indicator Lending Rates*

[33] Cannstar Cannex.

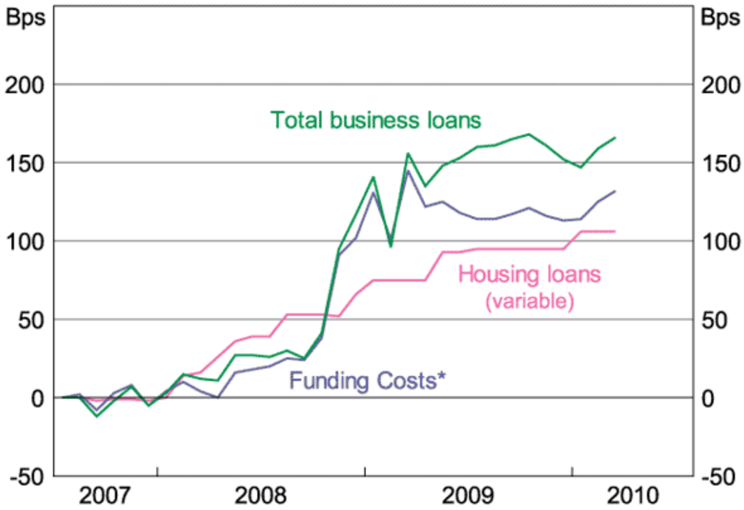
Banks are well aware that when they increase home loan rates by more than changes in the cash rate, they attract high levels of media attention and condemnation from politicians, but when they do the same thing with small business interest rates, the politicians remain silent. This situation can encourage banks to increase interest rates on their small business loans to in effect cross-subsidise home mortgage holders.

This issue was acknowledged in a public speech by Reserve Bank Assistant Governor Guy Debelle, where he stated that: *"Looking forward, the competitive state of the current [mortgage] market is reflected in the fact that home lending rates have not risen by as much as funding costs."* In relation to business loans, it was noted that *"In contrast, banks' business and personal loans have increased by even more relative to the cash rate and by more than the rise in funding costs."*[34]

This point is illustrated in the chart below:

Cumulative Change in Margins Between Various Interest Rates and the Cash Rate

Since June 2007



* Average on major banks' outstanding deposits and fixed and variable rate debt securities

Sources: APRA; RBA

Business organisation can also play a role in raising public awareness about the performance of banks in relation to small business borrowers. The NSW Business Chamber, for example, has worked with Canstar Cannex to create a data series which looks at the difference between mortgage lending rates and small business lending rates charged by the four big banks and four second tier banks. This information has been publicly promoted through media releases and member communications.

However, as a State Chamber our public voice is not as loud as the Federal Government's, and we believe if the Government was to also publicise such performances it would be more effective in driving change within the banking sector.

[34] Guy Debelle, *The State of the Mortgage Market,* Address to the Mortgage Innovation Conference, Sydney, 30 March 2010.

Improving competition

> *"The politicians say to change banks - I looked into doing that. They're all the same! There is no real competition because the banks were allowed to take over their competitors." – respondent to Victoria University's access to finance survey.*

On 12 December 2010, the Government announced its "Competitive and Sustainable Banking System" package. The package was designed to empower consumers, support smaller lenders, and secure the long-term sustainability of the banking system.

The NSW Business Chamber strongly supports most elements of the package, especially those that will improve competitive pressures within the banking system. However, the focus of the package appeared to be on the mortgage sector, with limited support for small business borrowing. We believe that greater attention should be given to this aspect of the banking sector in future.

During 2010 we made two submission to Senate Inquiries looking at access to finance and banking competition, and we put forward several recommendations aimed at improving competition in the banking sector. We believe that these recommendations remain relevant in the current environment.

Recommendation 4: That the Government remain open to new market entrants, both domestic and foreign, as a means of reinvigorating competition within this sector.

New market entrants provide an essential source of competition, which would help to place downward pressure on the margins currently being enjoyed by the major banks.

The major banks remain the dominant source of funds for small businesses. The Victoria University survey found that 43.8% of respondents had borrowed funds from one of the big four banks, while only 19.9% had borrowed from a smaller bank or finance company.

Recommendation 5: That further mergers between significant players in the banking sector not be allowed until competition has been restored. Subsequent mergers within the banking sector should be considered very carefully, with a particular focus on their potential impact on competition.

The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further consolidation of market power within the major banks should not be allowed in the current environment.

Recommendation 6: That the Productivity Commission complete a review looking at the degree of competition in the provision of business finance.

An open Productivity Commission review of the costs and constraints faced by small businesses in attracting finance could give this issue greater prominence, and assist in promoting competitive pressures within this part of the banking sector.

Among other things, this review could consider whether the one-size-fits-all approach often applied by the banks to small business lending is appropriate. Under current arrangements, profitable opportunities are often turned down by banks because the small business is operating is a sector which the bank considers to be 'bad business.'

Should you require further information or clarification of our submission, then please do not hesitate to contact Mr Micah Green, Economist on (02) 9458 7259 or via e-mail at micah.green@nswbc.com.au.

invigorating

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