The Senate

# Economics
# Legislation Committee

Australian Business Securitisation Fund Bill 2019 [Provisions]

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# Senate Economics Legislation Committee

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# Chapter 1

## Introduction

1.1 On 14 February 2019, the Senate referred the provisions of the Australian Business Securitisation Fund Bill 2019 (the bill) to the Economics Legislation Committee (the committee) for inquiry and report by 26 March 2019.[1]

1.2 The bill seeks to establish the Australian Business Securitisation Fund (ABSF) along with the ABSF special account, which will be credited with $2 billion incrementally between 1 July 2019 and 1 July 2023. The ABSF will invest in warehouse facilities and securitisations backed by small and medium enterprise (SME) loans, providing additional funding to smaller banks and non-bank lenders to on-lend to SMEs on more competitive terms. The bill also proposes a framework for investing funds of the ABSF in authorised debt securities.[2]

1.3 The administration of the ABSF will be managed by the Australian Office of Financial Management (AOFM).[3]

1.4 The Explanatory Memorandum (EM) notes that the focus of the ABSF's activities will be investing in securitised assets backed by SME loans, in either the warehouses or term market. Warehouses are securitisation facilities that allow a lender to fund loans until they have built up a large enough pool and track record to refinance them into the term securitisation markets. The EM further notes that this would support the ability of smaller lenders to grow and provide credit to underserviced segments of the SME lending market by improving the ability of these lenders to obtain funding from markets at a competitive price.[4]

1.5 The Treasurer, The Hon. Josh Frydenberg MP, noted that one of the greatest barriers for SMEs is access to affordable finance. The Treasurer further explained that the ASBF 'seeks to increase competition in the SME lending market by unlocking securitisation funding for smaller lenders, which will allow them to compete more effectively against the major banks'.[5]

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1 *Journals of the Senate*, No. 140, 14 February 2019, p. 4667.

2 *Explanatory Memorandum*, p. 5.

3 AOFM coordinated the Residential Mortgage Backed Securities (RMBS) investment program from 2008 to 2013.

4 *Explanatory Memorandum*, p. 5.

5 The Hon. Josh Frydenberg MP, Treasurer, *House of Representatives Hansard*, 13 February 2019, p. 1.

## Context

1.6 According to the Australian Bureau of Statistics (ABS), in 2016–17 there were over 2.2 million SMEs in Australia, accounting for around 68 per cent of private sector employment.[6]

1.7 The Productivity Commission report, *Competition in the Australian Financial System*, noted that there is evidence that some SMEs do have adequate access to finance. For example, ABS data shows that, in 2016–17, nearly 90 per cent of SMEs that applied for debt finance were successful.[7] However, the EM notes this figure does not take into account those SMEs that do not apply for finance due to a perception their application will be refused.[8]

1.8 The EM puts forward that the government has a role to play in this context:

> …intervention of the government as a longer-term investor who is willing to do due diligence despite the small scale of the market and is willing to be a flexible investor in potential deals has the potential to break this self-perpetuating cycle. A flexible investor would be one who is willing to have their share of the final deal scaled to what works best for the issuer and other investors.[9]

1.9 The government announced the establishment of an ABSF on 14 November 2018.[10] The purpose of the ABSF is to increase the availability and reduce the cost of finance to SMEs by making targeted interventions in the SME securitisation market.

1.10 The EM notes that securitisation is 'a method of funding whereby the cash flows from assets, such as loans, are packaged into tradeable debt securities that are generally (but do not need to be) tranched':[11]

> Each tranche has different risk characteristics. The cash flows from the underlying loans are used to make interest and principal payments to investors in the securities. These securities often only have recourse to the underlying assets, with generally no recourse to the originator of the assets.[12]

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6 Australian Bureau of Statistics, Selected Characteristics of Australian Business, cat. no. 8167.0, 2018; Australian Bureau of Statistics, Australian Industry, cat. no. 8155.0, 2018.

7 Productivity Commission, *Competition in the Australian Financial System*, 2018, p. 438.

8 *Explanatory Memorandum*, p. 15.

9 *Explanatory Memorandum*, p. 21.

10 The Treasury, The Hon. Josh Frydenberg MP, $2 billion fund to transform small business access to funding', *Media Release*, 'http://jaf.ministers.treasury.gov.au/media-release/051-2018/ (accessed 13 March 2019).

11 *Explanatory Memorandum*, p. 5.

12 *Explanatory Memorandum*, p. 5.

1.11 The EM also notes that the securitisation market has been an important source of funding for non-bank lenders and has been an important driver of competition for residential mortgages:

> Unlocking the securitisation market for SME loans, which is underdeveloped in Australia, will allow smaller lenders and non-bank lenders to compete more effectively, and increase the availability of lending and reduce prices in the market.[13]

1.12 The Department of the Treasury (Treasury) conducted a consultation process on the exposure draft legislation for the ABSF between 21 December 2018 and 16 January 2019. Treasury received 11 public submissions which are available on its website.[14] As part of the process, Treasury released an exposure draft and explanatory materials, as well as a draft Investment Mandate for consideration.

1.13 On 13 March 2019, Treasury advised that indicative draft rules and investment mandate directions for the Fund had been published on the Treasury website.[15]

## Provisions of the bill

1.14 The bill is set out in three parts. Part 1 sets out the objects of the ABSF, arrangements for commencement, application to the Crown, key definitions, extension to external territories and extra-territorial application.

1.15 Part 2 establishes the ABSF and the ABSF special account; provides for the types of investments that can be made by the ABSF; and credits $2 billion into the ABSF special account between 1 July 2019 and 1 July 2023.

1.16 Part 3 sets out the constitutional limits of the ABSF, provides for the responsible minister's powers to be delegated, and provides for regular reporting and reviews of the ABSF.[16]

### *Establishment of the ABSF*

1.17 In establishing the ABSF and the ABSF special account, the responsible minister is given the power to invest amounts in the ABSF special account on behalf of the Commonwealth in authorised debt securities that meet certain requirements. Authorised debt securities are debt securities that:

- are issued by a trust or a body corporate that is a special purpose vehicle; and
- are expressed in Australian dollars; and

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13 *Explanatory Memorandum*, p. 6.

14 The Treasury, Consultations, *Australian Business Securitisation Fund*, https://treasury.gov.au/consultation/c2018-t349315/ (accessed 13 March 2019).

15 The Treasury, *Australian Business Securitisation Fund*, https://treasury.gov.au/small-business/absf/ (accessed 13 March 2019).

16 *Explanatory Memorandum*, p. 6.

- relate to one or more amounts of credit provided to one or more debtors where each amount of credit:
  - is provided wholly or predominantly for business purposes; and
  - is less than $5 million or any other amount prescribed in the rules; and
  - complies with other requirements or restrictions prescribed in the rules relating to amounts of credit and
- complies with any other requirements or restrictions prescribed in the rules relating to authorised debt securities.[17]

***Investment Mandate***

1.18 Part 2 also provides for the responsible minister to give directions in relation to the ABSF through the creation of an Investment Mandate.

1.19 The bill sets out that the Investment Mandate may include directions about:

- strategies and policies to be followed for making investments;
- decision-making criteria for making investments;
- limits on making investments;
- risk and return relating to investments;
- governance arrangements relating to investments; and
- any other matters the minister thinks appropriate.[18]

***ABSF special account***

1.20 The ABSF special account will be credited with $2 billion between 1 July 2019 and 1 July 2023. The $2 billion will be credited to the ABSF in the following increments:

- $250 million on 1 July 2019;
- $250 million on 1 July 2020;
- $500 million on 1 July 2021;
- $500 million on 1 July 2022; and
- $500 million on 1 July 2023.[19]

1.21 The ABSF special account will also be credited with income derived from the ABSF's investments, capital returns or other financial distributions relating to the

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17 *Explanatory Memorandum*, p. 9.

18 *Explanatory Memorandum*, p. 10.

19 *Explanatory Memorandum*, p. 11.

ABSF's investments, and the proceeds of realising the ABSF's investments. This will allow the ABSF to reinvest its capital and earnings.[20]

### *Review of the ABSF*

1.22 Part 3 stipulates that there will be a yearly update on the operation of the ABSF in an annual report prepared by the Chief Executive Officer of the AOFM and given to the Minister under section 46 of the *Public Governance and Performance Accountability Act 2013*.[21]

1.23 Part 3 also requires the responsible minister to commence two reviews into the ABSF. The first review is to be undertaken as soon as possible after the second anniversary of the commencement of the bill. The second review is to be undertaken as soon as possible after the fifth anniversary of the commencement of the bill. The bill commences on the day after Royal Assent. The reviews must include a review of the effectiveness of the ABSF in meeting its objectives.[22]

## Draft Investment Mandate and rules

1.24 The draft Investment Mandate,[23] released by Treasury on 13 March 2019, includes directions relating to:

- Investment Strategies and Policies;
- Investment decision-making criteria; and
- Investment risk and return.

1.25 In relation to the level of risk and return on investment decisions made by the responsible minister, the draft Investment Mandate proposes that, in making investments, the Minister must:

> (a) ensure that the investments of the Fund have an acceptable but not excessive level of risk, having regard to the objects of the Act; and
>
> (b) aim to achieve over the medium-term a net financial return on the investments of the Fund that is not lower than the corresponding return on the Bloomberg AusBond Treasury 0–1 Yr Index.[24]

1.26 The draft rules specify that 'a major bank' or 'a body corporate that is a subsidiary of a major bank' cannot be credit providers under the future Australian Business Securitisation Fund Act (ABSF Act). The draft rules also propose that for

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20 *Explanatory Memorandum*, p. 11.

21 *Explanatory Memorandum*, p. 14.

22 *Explanatory Memorandum*, p. 14.

23 Australian Government, *Draft Australian Business Securitisation Fund Investment Mandate Directions 2019*, https://static.treasury.gov.au/uploads/sites/1/2019/03/ABSF_-_Investment_Mandate.pdf (accessed 14 March 2019).

24 Australian Government, *DraftAustralian Business Securitisation Fund Investment Mandate Directions 2019*, p. 2, https://static.treasury.gov.au/uploads/sites/1/2019/03/ABSF_-_Investment_Mandate.pdf (accessed 14 March 2019).

the purposes of paragraph 12(4)(d) of the future ABSF Act, the debt security must not be a first loss security.[25]

## Compatibility with Human Rights

1.27 The EM notes that the bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.[26]

## Financial impact

1.28 Further to the crediting of the ABSF special account with $2 billion, the establishment of the ABSF has the following financial impact:

***Table 1: Financial impact of the establishment of the ABSF***[27]

| ***2018–19*** | ***2019–20*** | ***2020–21*** | ***2021–22*** |
|---|---|---|---|
| -2.9 million | -7.646 million | -6.501 million | -10.218 million |

1.29 The EM also notes that the measures in the bill are estimated to increase compliance costs to businesses by $0.1 million per year:

> The compliance costs imposed by the ABSF primarily relate to the time required for additional engagement with the ABSF pre-investment, for the period of ABSF involvement in the market (including periodic reviews), and for additional legal and structuring advice costs.[28]

## Conduct of the inquiry

1.30 The committee advertised the inquiry on its website. It also wrote to relevant stakeholders and interested parties inviting written submissions by 6 March 2019. The committee received 10 submissions, which are listed at Appendix 1.

1.31 The committee held a public hearing for this inquiry in Sydney on 15 March 2019. A list of witnesses who appeared at the hearing can be found at Appendix 2.

1.32 References to the Committee Hansard are to the Proof Hansard and page numbers may vary between the Proof and Official Hansard transcripts.

1.33 The committee would like to thanks all individuals and organisations that made submissions and participated in the public hearing.

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25 Australian Government, *Draft Australian Business Securitisation Fund Rules 2019*, p. 2, https://static.treasury.gov.au/uploads/sites/1/2019/03/ABSF_-_Rules.pdf (accessed 14 March 2019).

26 *Explanatory Memorandum*, p. 37.

27 *Explanatory Memorandum*, p. 3.

28 *Explanatory Memorandum*, p. 3.

# Chapter 2

## Views on the bill

2.1 As discussed in chapter 1, the Australian Business Securitisation Fund Bill 2019 (the bill) seeks to establish the Australian Business Securitisation Fund (ABSF) along with the ABSF special account, which will be credited with $2 billion incrementally between 1 July 2019 and 1 July 2023. The ABSF will invest in warehouse facilities and securitisations backed by small and medium enterprise (SME) loans, providing additional funding to smaller banks and non-bank lenders to on-lend to SMEs on more competitive terms. The bill also proposes a framework for investing funds of the ABSF in authorised debt securities.[1]

2.2 The administration of the ABSF will be managed by the Australian Office of Financial Management (AOFM).[2]

2.3 This chapter examines evidence received in submissions as well as at the public hearing. In particular, this chapter focusses on access to finance for SMEs, competition in the small lenders sector, AOFM's expertise in relation to managing the ABSF, the terms of the Investment Mandate, and the financing of the ABSF special account.

### General comments

2.4 Participants in the inquiry supported the establishment of the ABSF and its aim to increase the availability of affordable finance to SMEs. A majority of submitters considered that the establishment of a securitisation market would increase competition among SME lenders and that, in turn, could provide greater access to finance for SMEs.[3]

2.5 In particular, Mr Beau Bertoli from Prospa Advance Pty Ltd (Prospa), believed that the fund would deliver the government's policy objective of increasing the availability of affordable finance for small-business owners, noting that the establishment of the ABSF 'will significantly accelerate the supply of private debt capital into the market for unsecured business loans, and it will help small businesses invest in their growth'.[4]

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1 *Explanatory Memorandum*, p. 5.

2 AOFM coordinated the Residential Mortgage Backed Securities (RMBS) investment program from 2008 to 2013.

3 See, for example, Narrow Road Capital, *Submission 1*, p. 1; Australian Securitisation Forum, *Submission 3, p. 2*; Australian Chamber of Commerce and Industry, *Submission 5*, p. 2; Australian Finance Industry Association, *Submission 6*, p. 2; Prospa Advance Pty Ltd, *Submission 8*, p. 2;

4 Mr Beau Bertoli, Co-founder and Joint CEO, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 15.

2.6 Mr Jonathan Rochford from Narrow Road Capital agreed that the ABSF could have a positive impact for SME lenders as well as SMEs:

> …the ABSF, if implemented efficiently and prudently, will meaningfully increase the availability of credit and reduce the cost of credit for well-managed and well-capitalised small businesses, and I emphasise 'well-managed and well-capitalised'.[5]

2.7 Mr Rochford further noted that the ABSF 'will be profitable to the taxpayer' given that the government would be a lender and investor, making a profit on lending.[6]

2.8 Mrs Jill Lawrence from the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) noted that the ASBFEO strongly supports the ABSF. However, along with a number of other submitters, raised some concerns about the implementation of the ABSF and those details of its operation which have not yet been finalised.[7] These concerns are examined later in this chapter.

## Access to finance for small and medium enterprises

2.9 The ASBFEO have stated that 'limited competition—and risk-weighted appetite focussed on real estate—limits lending to SMEs'.[8]

2.10 CPA Australia noted, however, that not all SMEs had difficulty accessing finance. In fact, CPA put forward:

> Preliminary data from our 2018 soon-to-be-published Asia-Pacific Small Business Survey shows that 47 per cent of Australian small businesses that required external finance in 2018 found the experience easy or very easy, the second highest result of the ten markets surveyed; and higher than the Australian result from 2017. Meanwhile, 32 per cent of Australian respondents reported the experience was difficult or very difficult.[9]

2.11 The Productivity Commission (PC) describes SME's general interaction with the banking system as mainly debt finance—term loans, overdrafts, lines of credit and business credit cards. The PC quoted ABS data in its 2018 *Competition in the Australian Financial System* report:

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5 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6.

6 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 7.

7 See, for example, Narrow Road Capital, *Submission 1;* Australian Securitisation Forum, *Submission 3;* Office of the NSW Small Business Commissioner, *Submission 7*; Australian Small Business and Family Enterprise Ombudsman, *Submission 10*.

8 Australian Small Business and Family Enterprise Ombudsman, *Affordable capital for SME growth*, June 2018, p. 11, https://www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-affordable-capital-for-SME-growth.pdf (accessed 13 March 2019).

9 CPA Australia, *Submission 4*, p. 1.

> In Australia, SMEs that are successful in raising [debt finance] loans generally do so by mortgaging real estate (usually a house).
>
> - Nearly 90% of SMEs that decided to apply for debt finance were successful.
> - But with home ownership in the key entrepreneurial period of life (ages 25-34) down by a third over the past 25 years, the continued emphasis on home ownership in Australia's risk weighting system will increasingly inhibit SME lending.[10]

2.12 Mr Rochford from Narrow Road Capital also noted that an SME's access to finance was highly dependent on what collateral the SME has to offer:

> If you have your own home, there's a very good chance you can get a loan against it. If you're buying a vehicle and you can put that up as security, whether it's leased or there's a loan against it, there's a good chance you can get capital. If you don't have either of those things, if you're looking to use the cash flows of the business, it is much, much harder.[11]

2.13 Mr Warren Tease from the Department of the Treasury (Treasury) noted that the statistics on SME applications for finance were not conclusive, noting there is not extensive data that exists in relation to this issue. Mr Tease commented:

> The conclusion that 90 per cent of businesses get their debt funding is correct, but there may be a degree of self-selection in that data. For small businesses it's very costly to raise a loan, so businesses may self-select. Businesses that are likely to get debt funding are more likely to apply and others may choose not to.[12]

2.14 The EM also notes that the relative ease with which SMEs can access finance has declined more recently:

> The Sensis Business Index September 2018 survey suggests that, 31 per cent of existing SMEs that have tried to access finance found it relatively hard. The survey uses the same definition as ABS for SMEs and respondents were able to select from three options: relatively easy, average and relatively hard.[13]

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10 Productivity Commission, *Competition in the Australian Financial System*, 2018, p. 435.

11 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 8.

12 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 37.

13 *Explanatory Memorandum*, p. 15.

### *Awareness of financing options*

2.15 A number of submitters to the inquiry noted that SMEs' awareness of financing options, beyond the major, banks was limited.[14] In particular, CPA Australia noted that Australian SMEs are highly reliant on banks for financing.[15]

2.16 Scottish Pacific noted in their submission to the Treasury consultation on the ABSF that the lack of awareness regarding options, rather than the availability of funds, is 'the sticking point for improving SMEs' access to funding'.[16]

2.17 Mr Peter Langham, Chief Executive Officer (CEO) of Scottish Pacific pointed out that many SME owners are not financially trained and require a significant amount of assistance to access appropriate funding. Mr Langham considered that education was an important element in ensuring the success and profitability of SMEs in Australia.[17]

2.18 Ms Anna Fitzgerald from Prospa noted that they have market research which shows that 'the awareness of alternative lending options[18] is only at 50 per cent amongst small-business owners and that, amongst those that are aware, consideration is only at 15 per cent'.[19] Ms Fitzgerald explained some of the reasons that alternative lending options are considered so little by SMEs:

> It's partly because it is new and they need to feel that their lending partner is trustworthy, although that might seem strange since we are the ones providing the funding. What they're doing is trading off, potentially, the need to have all their finances in one place with the need for someone to say yes.

2.19 Mr Tease from Treasury noted that, together with the Reserve Bank of Australia, Treasury had held a number of roundtables with small-business organisations and small SME funders, which highlighted the gap in awareness of alternative lending options:

> Information and the lack of it, on both the lenders' part—the new lenders coming into the market don't necessarily know who their future clients are going to be, so they can't find the SMEs themselves, and, on the other side,

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14 See, for example, CPA Australia, *Submission 4*, p. 1; Scottish Pacific, *Submission to Treasury consultation on the Australian Business Securitisation Fund*, p. 3; Prospa Advance Pty Ltd, Submission 8; Office of the NSW Small Business Commissioner, *Submission 7*, p. 1.

15 CPA Australia, *Submission 4*, p. 1.

16 Scottish Pacific, *Submission to Treasury consultation on the Australian Business Securitisation Fund*, p. 3.

17 Mr Peter Langham, Chief Executive Officer, Scottish Pacific Business Finance, *Committee Hansard*, 15 March 2019, p. 11.

18 Alternative lending options are generally considered to be lenders that are not one of the major banks or other large financial institution.

19 Ms Anna Fitzgerald, Group Head of Corporate Relations, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 18.

> the SMEs don't necessarily know who the new lenders are and how they go about raising finance. That's a definite issue in the market.[20]

2.20 Submitters considered that the establishment of a government-led ABSF would have a positive impact on SME lenders and in turn on SMEs. In particular, Ms Fitzgerald considered that the ABSF would significantly enhance access to funds for SMEs; noting that increasing awareness and consideration of alternative financing options through the ABSF would assist in solving the problem.[21]

2.21 Ms Helen Gordon, CEO of the Australian Finance Industry Association (AFIA), put forward that the government's involvement in the ABSF would in itself generate interest in the fund. Ms Gordon considered that this would increase awareness not only of the fund but of other alternative lending options as well.[22]

2.22 Ms Gordon also suggested that an education campaign would be one way of increasing awareness of alternative lenders, which would not require an SME owner to offer up their family home as collateral. Ms Gordon also pointed to the availability of equipment finance, which allows an SME to access funds specifically for equipment related to their business.[23]

## Competition in the small lenders sector

2.23 Mr Tease from Treasury explained that for the ABSF to be effective, it has to increase competition in the financial system by developing the capacity of small non-bank lenders to compete with the large banks.[24]

2.24 Submitters agreed that the ABSF had the potential to increase competition, and hoped that the increased competition would lead to more affordable finance for SMEs.[25]

2.25 Mr Chris Dalton, CEO of the Australian Securitisation Forum (ASF) noted that there are some constraints to the growth of the small lenders sector. Mr Dalton put forward that:

> 'the fact that the government is willing to provide finance to invest alongside other investors in the sector will provide greater capacity for them to grow their loan books, and that will be beneficial from a

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20 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 36.

21 Ms Anna Fitzgerald, Group Head of Corporate Relations, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 18.

22 Ms Helen Gordon, Chief Executive Officer, Australian Finance Industry Association, *Committee Hansard*, 15 March 2019, p. 22.

23 Ms Helen Gordon, Chief Executive Officer, Australian Finance Industry Association, *Committee Hansard*, 15 March 2019, p. 22.

24 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 35.

25 See, for example, Narrow Road Capital, *Submission 1*, p. 1; Australian Securitisation Forum, *Submission 3*, pp. 1–2; Australian Chamber of Commerce and Industry, *Submission 4*, p. 1.

> competition point of view. It will potentially allow some of the newer lenders to obtain scale at a faster pace than what might otherwise have been the case'.[26]

2.26 Mr Rochford from Narrow Road Capital considered that, if implemented correctly, the ABSF will help those smaller lenders become bigger lenders:

> There will be more [competition], and they will be able to offer lower rates as established lenders than they could have as emerging lenders. The ABSF bridges that gap and helps bring more competition to the market.[27]

2.27 Ms Gordon from AFIA considered that the establishment of the ABSF would have an impact across the SME lending market:

> Yes, they're smallish numbers here, and $2 billion, but that money will then create data points. As deals go over a long time, there will be new data available to investors and credit providers into warehouses. That will make it easier for them over time to grow that market. Other people may not participate in the fund directly as a credit provider, initially, or an investor, but over time they will also see benefits from the creation of that market, that expansion.[28]

2.28 Mr Tease from Treasury explained that in entering the SME funding space, the government does not want to crowd out existing market players or distort the market:

> We wanted the AOFM to effectively have a light-touch intervention in the market through which it worked with existing infrastructure to help the existing infrastructure develop and, in doing so, strengthen the existing infrastructure, making it easier for the AOFM to exit the market at some point in the future.[29]

2.29 Mr Tease described the ABSF's success as 'a deeper market with more players, and more players with a longer track record'. Mr Tease noted:

> When we talked to market participants, it was clear that the issue of them just joining the market and having a short track record was an impediment to their growth. So there would be players that have a longer track record and there would be a market in which some of the important infrastructure of securitisation develops.[30]

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26 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 15 March 2019, pp. 1–2.

27 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 7.

28 Ms Helen Gordon, Chief Executive Officer, Australian Finance Industry Association, *Committee Hansard*, 15 March 2019, p. 24.

29 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 34.

30 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 35.

2.30 Mr Tease also explained that the ABSF had the potential to lower the overall cost of finance to SMEs:

> When we think about the potential impact on funding costs, there are a number of issues to consider. The first is that, at least in the initial stages of the fund, the AOFM has the capacity to provide funding at a discount rate to the market, so that will be a direct impact on the cost of funding in the market. Over time, if we see the market infrastructure develop, and particularly if we see SME lenders grow and their scale increase, naturally the marginal costs of their business, including the funding costs, will go down as part of that process.[31]

2.31 Mr Michael Bath from the AOFM commented that the ABSF would likely have an impact on competition and affordable finance for SMEs:

> I think we'll see a material difference, but I don't know how material that difference will be. We'll be monitoring it, and that will presumably be the focus of the reviews at two and five years.[32]

## Australian Office of Financial Management

2.32 Several submitters noted that the AOFM would be responsible for administering the ABSF and highlighted that this work would be in a highly specialised area of the financial markets.[33]

2.33 Goldfields Money and Narrow Road Capital each noted AOFM's success in implementing the Residential Mortgage Backed Securities (RMBS) investment program from 2008 to 2013.[34]

2.34 Mr Raj Bhat from Prospa considered that AOFM has the necessary experience and skill set in the core securitisation market to manage the ABSF.[35]

2.35 Mr Dalton from the ASF also considered that, given AOFM's experience with the RMBS program, the ABSF would 'be in good hands'.[36] However, Mr Dalton also noted that managing the ABSF would hold different challenges to the management of the RMBS, as 'the AOFM and government intervention is not to support an existing

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31 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 40.

32 Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, p. 41.

33 See, for example, Narrow Road Capital, *Submission 1*, p. 1; Australian Securitisation Forum, *Submission 3*, p. 2.

34 See, for example, Goldfields Money, *Submission 9*, p. 2; Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6; Mr Raj Bhat, Head of Group Capital Management, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 20.

35 Mr Raj Bhat, Head of Group Capital Management, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 20.

36 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 15 March 2019, p. 1.

market but rather to support the development and deepening of a newer sector of the market'.[37]

2.36 Mr Rochford from Narrow Road Capital also noted that although the RMBS and the ABSF share some similarities, 'the key part of the ABSF's activities will be an order of magnitude more complex than the previous program'. Mr Rochford recommended that the AOFM run an open tender process to determine which firm or firms are best placed to assist it and ensure that a cost-efficient outcome is reached.[38]

2.37 Narrow Road Capital also considered that AOFM would need to find suitable firms to source, analyse, decision and manage the investments of the ABSF, noting that the expertise required around structuring, documentation and credit analysis is highly specialised.[39]

2.38 Mr Rochford pointed out that the ABSF will be entering a market where there is a limited but growing number of investors that provide debt finance to emerging SME lenders:

> It is recommended that the ABSF work with these existing finance providers, leveraging their expertise and capital bases. In doing this, emerging SME lenders are likely to be best assisted on their journey to becoming established lenders who can provide more competitive financing to SMEs.[40]

2.39 Mr Rochford noted that the AOFM are consulting widely in order to source the necessary expertise:

> My understanding is that they recognise the limits of their capabilities and where they'll need external expertise. They are definitely engaging with the market to ensure that they have the expertise available to them to do this.[41]

2.40 Mr Bath from the AOFM noted the agency's experience with RMBS program; while also acknowledging that AOFM would seek expertise in relation to the highly specialised aspects of the ABSF:

> I think our experience in the RMBS space, which was at the heavily secured end of the spectrum, speaks for itself. We would not have too many concerns about operating at that end of the spectrum. In the unsecured space, it's significantly greater risk to the taxpayer, and we would obviously

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37 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 15 March 2019, p. 1.

38 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6.

39 Narrow Road Capital, *Submission 1*, p. 1.

40 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6.

41 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 9.

> approach it accordingly. My expectation is that we would hire a significant amount of expertise.[42]

2.41 Mr Bath also noted that additional resources had been allocated to the AOFM in the portfolio additional estimates statements. AOFM has provided for seven full-time-equivalent staff whose roles will likely focus on credit analysis and due diligence of investments.[43]

## Investment Mandate

2.42 As noted in chapter 1, the draft Investment Mandate,[44] released by Treasury in March 2019, includes directions relating to:

- Investment Strategies and Policies;
- Investment decision-making criteria; and
- Investment risk and return.

2.43 Some submitters noted that the draft Investment Mandate did not contain a lot of detail.[45] However, others considered that the general guidelines set out in the Investment Mandate would increase flexibility for the AOFM to manage its investments.[46]

2.44 For example, Mr Rochford from Narrow Road Capital considered that the broadness of the Investment Mandate was positive:

> It is helpful because, once this process begins and someone, whether that's managers who are hired for the AOFM or the AOFM itself, hangs out the shingle and says, 'We're open for business,' you will get hit with a wave of emerging lenders looking for finance. That will come straight away, and that's why the number of how much you do in the first 12 or 24 months could be far higher than what's envisaged. At the moment, there's flexibility to say, 'Yes, you get up,' because good people asking for the money is important.[47]

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42 Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, p. 36.

43 Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, p. 43.

44 Australian Government, *Draft Australian Business Securitisation Fund Investment Mandate Directions 2019*, https://static.treasury.gov.au/uploads/sites/1/2019/03/ABSF_-_Investment_Mandate.pdf (accessed 14 March 2019).

45 See, for example, Australian Small Business and Family Enterprise Ombudsman, *Submission 10*; Office of the NSW Small Business Commissioner, *Submission 7*.

46 See, for example, Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6; Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, pp. 35–36.

47 Mr Jonathan Rochford, Portfolio Manager, Narrow Road Capital, *Committee Hansard*, 15 March 2019, p. 6.

2.45 Mr Bertoli from Prospa made a number of recommendations in relation to the Investment Mandate:

> We believe that access to the fund should be granted to lenders that meet set criteria and have requisite governance and infrastructure to ensure their internal funds reflect the underlying credit risk. It's important that lenders with a commitment to prudent lending standards, with dispute resolution options, such as membership of ACFA, and with a track record that can give confidence to the government are given access to the fund.[48]

2.46 Ms Gordon from AFIA noted that the draft Investment Mandate does set out how the AOFM will select investments:

> It looks to be on a competitive process along with the government's desired objectives here. Everyone in this market—investors, credit providers and small businesses—will benefit over time. This $2 billion—I don't want to use the word 'seed', because there is a market there already—would really help develop the securitisation market for small-business lending.[49]

2.47 Mr Bath from the AOFM commented that the Investment Mandate is 'deliberately broad', explaining:

> I think that's largely because SME lending stretches from the financing of a big piece of equipment on a secured basis all the way through to a coffee shop that needs to get some working capital—cashflow type finance. It's a much more heterogeneous market than mortgages, which are financed through mortgage backed security. We deliberately sought a very broad mandate. That will provide us with flexibility so that we can, if you like, see where the need is greatest in a market sense as opposed to an individual lender-and-borrower sense.[50]

2.48 A number of submitters including the ASBFEO, the Office of the NSW Small Business Commissioner, and Prospa considered that the ABSF Investment Mandate would need to include a suitable risk appetite and a reasonable rate of return in line with its objectives.[51]

2.49 For example, Mrs Lawrence from the ASBFEO suggested that the Investment Mandate should include an explicit rate of return in order that it 'doesn't creep up'.[52] Mrs Lawrence explained:

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48 Mr Beau Bertoli, Co-founder and Joint CEO, Prospa Advance Pty Ltd, *Committee Hansard*, 15 March 2019, p. 15.

49 Ms Helen Gordon, Chief Executive Officer, Australian Finance Industry Association, *Committee Hansard*, 15 March 2019, p. 24.

50 Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, pp. 35–36.

51 See, for example, Australian Small Business and Family Enterprise Ombudsman, *Submission 10*; Office of the NSW Small Business Commissioner, *Submission 7;* Prospa Advance Pty Ltd, *Submission 8*.

52 Mrs Jill Lawrence, Acting Director Advocacy, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 15 March 2019, p. 27.

> If it's clear that the expected rate of return is lower than the market rate of return, because the intention of this fund is to increase competition, that sends a clear message to the rest of investors in the warehouse securitisation space of how they can best support this initiative. Our concern is a change of appetite for what this fund and the return against this fund should achieve, and we're concerned that the ultimate beneficiaries, the small businesses, will find that there's no difference in the availability of capital because this fund has to return five per cent plus. So we would like it explicit.[53]

2.50 In relation to the level of risk and return on investment decisions made by the responsible minister, the draft Investment Mandate proposes that, in making investments, the Minister must:

> (a) ensure that the investments of the Fund have an acceptable but not excessive level of risk, having regard to the objects of the Act; and
>
> (b) aim to achieve over the medium-term a net financial return on the investments of the Fund that is not lower than the corresponding return on the Bloomberg AusBond Treasury 0-1 Yr Index.[54]

2.51 Mr Tease from Treasury pointed out that, in accordance with the Investment Mandate, the AOFM is obliged to find appropriate risk parameters in which it invests.[55]

2.52 Mr Michael Bath from the AOFM confirmed that finding appropriate risk parameters would an important element of the AOFM's role:

> It will be a pretty significant due diligence process, and it will be more detailed than the sort of due diligence that we undertook when we were investing in AAA-rated RMB securities, by a long margin.[56]

## ABSF special account

2.53 As noted in chapter 1, the ABSF special account will be credited with $2 billion between 1 July 2019 and 1 July 2023. The $2 billion will be credited to the ABSF in the following increments:

- $250 million on 1 July 2019;
- $250 million on 1 July 2020;
- $500 million on 1 July 2021;

53 Mrs Jill Lawrence, Acting Director Advocacy, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 15 March 2019, p. 27.

54 Australian Government, *Draft Australian Business Securitisation Fund Investment Mandate Directions 2019*, p. 2, https://static.treasury.gov.au/uploads/sites/1/2019/03/ABSF_-_Investment_Mandate.pdf (accessed 14 March 2019).

55 Mr Warren Tease, Chief Adviser, Financial System Division, Department of the Treasury, *Committee Hansard*, 15 March 2019, p. 39.

56 Mr Michael Bath, Head of Global Markets and Business Strategy, Australian Office of Financial Management, *Committee Hansard*, 15 March 2019, p. 43.

- $500 million on 1 July 2022; and
- $500 million on 1 July 2023.[57]

2.54 The ABSF special account will also be credited with income derived from the ABSF's investments, capital returns or other financial distributions relating to the ABSF's investments, and the proceeds of realising the ABSF's investments. This will allow the ABSF to reinvest its capital and earnings.[58]

2.55 Some submitters suggested that the proposed increments for crediting the ABSF special account could be altered in order to have a bigger impact for SME lenders. In particular, Prospa suggested:

> We believe the biggest impact will be derived by bringing forward funds so that $600m is available in year 1, $500m in year 2 and $300m per annum thereafter.[59]

2.56 The ASF also commented that there should be greater flexibility in allocations that can be made to the ABSF in its first two years of operation, that is, in 2019 and 2020.[60]

2.57 Mr Dalton from ASF suggested the current allocation of $250 million in 2019 and 2020 may not be sufficient to meet the level of interest in the ABSF when it is first established. He proposed that:

> …if the program kicked off and was able to find opportunities to invest and encourage greater funding and competition for lending to small business, that there should be some flexibility in the legislation or in the investment mandate of the AOFM to increase or go beyond those allocations of $250 million. We had suggested through our discussions with members that maybe there needed to be the possibility of allocating up to $600 million in the first year or two.[61]

## Committee view

2.58 The committee considers that SMEs are a vital part of the Australian economy and acknowledges that one of the greatest barriers for SMEs' growth is access to affordable finance. The committee also notes that there is currently a lack of competition in the SME lending market, and that this is likely impacting SMEs' access to affordable finance.

2.59 The committee notes the broad and substantial consultation by the AOFM and Treasury for the bill. The committee believes that the establishment of a government-led securitisation fund will assist in increasing competition in the SME

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57 *Explanatory Memorandum*, p. 11.

58 *Explanatory Memorandum*, p. 11.

59 Prospa Advance Pty Ltd, *Submission 8*, p. 3.

60 Australian Securitisation Forum, *Submission 3*, p. 2.

61 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 15 March 2019, p. 2.

lending market by unlocking securitisation funding for smaller lenders, allowing them to compete more effectively against the major banks.

2.60 The committee notes that the ABSF's draft Investment Mandate will require an acceptable level of risk and return on investment decisions, and that the setting of these parameters will rest with the AOFM.

2.61 The committee notes the AOFM's successful implementation of the RMBS investment program from 2008 to 2013; and considers that the AOFM is well placed to manage the ABSF. AOFM has acknowledged that some aspects of the ABSF are highly specialised and is prepared to seek that expertise where it is required.

2.62 The committee considers that the establishment of the ABSF will assist in stimulating greater competition amongst SME lenders, which will lead to the availability of more affordable finance for SMEs in the medium to longer term.

**Recommendation 1**

**2.63 The committee recommends that the bill be passed.**

**Senator Jane Hume**
**Chair**

# Additional Comments from Labor Senators

1.1 Labor Senators support this legislation, but do have remaining concerns about the Australian Business Securitisation Fund (ABSF).

1.2 The first concern is that the development of this legislation has been rushed.

1.3 The second concern is that the ABSF will not make a meaningful difference to the cost of small to medium enterprise (SME) debt finance. It might also take years for the ABSF to make any difference given the funding profile that has been set.

1.4 The remaining concerns primarily relate to the structure of the fund and whether taxpayers will be unnecessarily exposed to loss in the effort to reduce the cost of debt financing for SMEs.

1.5 Labor has a strong suite of policies to support small businesses. With a Shorten Labor Government, 99 per cent of businesses will receive a tax cut, no business will have their tax rate increased, and all businesses will be able to plan and invest with confidence and certainty. Labor has also announced its Australian Investment Guarantee, which will help boost much-needed investment in the economy and Labor has legislated its Small Business Access to Justice Policy.

## The development of this legislation has been rushed

1.6 The committee heard evidence that the policy work on the ABSF started as late as September last year and that the government's timeline for introducing and passing a bill truncated the consultation process.

1.7 Treasury officials stated that consultation on government involvement in securitised business lending started as late as August to September last year:

> Early in the process, in August and September last year, the Treasury engaged with a range of market participants in both one-on-one meetings and roundtables to discuss, in general, the workings of the SME securitisation market and issues that were constraining the development of the market, and to get general feedback from market participants about their thoughts on the necessity and some form of government intervention in the market—whether it's necessary and whether it would be successful.[1]

1.8 The Australian Finance Industry Association (AFIA) indicated that the government's timeframes impacted the consultation process:

> I guess my starting point would be that we were conscious that the time line was impacted by the announcement of an intention by the government to implement and a need to with the remaining time available at that point—still, how much time available was there to actually have a bill introduced and passed was a driving factor in terms of time available to commit and have this pass.[2]

1 Mr Warren Tease, *Committee Hansard*, p. 34.

2 Ms Helen Gordon, *Committee Hansard*, p. 22.

## The ABSF is unlikely to make a meaningful difference to the cost of SME debt financing

1.9 Stakeholders were very guarded when asked by how much the ABSF would reduce the cost of debt financing for SMEs.

1.10 This is in contrast to the Treasurer's Media Release announcing the ABSF, in which the Treasurer stated:

> The Liberal National Government will significantly enhance access to funds for small business across the country.[3]

1.11 The Australian Securitisation Forum, when asked about the impact of the ABSF, stated that a meaningful difference was an ambitious target and that any benefits could take more than three years to materialise:

> Senator KETTER: So you're suggesting that the cost of capital to small businesses is unlikely to be reduced in any meaningful way?
>
> Mr Dalton: The view that we're putting is that that's an ambitious target. I think that the main impact will come through improving access to funding, providing competition and establishing an avenue through the securitisation market to finance this sector on an ongoing, sustainable basis. The view of our association is that seeing significant reductions in the cost of sums to small business is more ambitious and may take a longer time to work through than the first two to three years of this program.[4]

1.12 Narrow Road Capital emphasised that the ABSF would only make an incremental difference, and that small businesses should preferably be financed through equity and that only well-managed and well-capitalised SMEs would stand to benefit:

> Firstly, the ABSF should be considered an incremental rather than a transformational program in assisting small and medium businesses to obtain debt finance. As most small businesses are high-risk entities with a high probability of failing, their activities are best financed by equity capital, typically from the owner's personal savings. There should be a realistic expectation from the outset that the ABSF will not and should not suddenly make debt finance available to all or the majority of SMEs. As financial history has shown us, if there were a large-scale increase in available SME credit, the inevitable outcome would be a wave of insolvencies, with substantial losses borne by employees, trade creditors and taxpayers. However, having said this, the ABSF, if implemented efficiently and prudently, will meaningfully increase the availability of credit and reduce the cost of credit for well-managed and well-capitalised small businesses, and I emphasise 'well-managed and well-capitalised'.[5]

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3 The Hon. Josh Frydenberg MP, *$2 billion fund to transform small business access to funding*, 14 November 2018, accessed via http://jaf.ministers.treasury.gov.au/media-release/051-2018/

4 Mr Christopher Dalton, *Committee Hansard*, p. 3.

5 Mr Jonathan Rochford, *Committee Hansard*, p. 6.

1.13 Scottish Pacific stated that they did not think that emerging businesses would see a reduced cost of debt financing through efforts of the ABSF:

> From what I've seen of how this proposal is supposed to work, I don't think it will, because it's going to be a small part of the overall lending package. But I'd also add—having lent to business owners for well over 30 years—that the cost of borrowing isn't going to stop them borrowing; it's the ease of borrowing and the security they've got to offer.[6]

1.14 AFIA stated that the two billion dollar fund size was not large enough, and that the current size of the fund was chosen to manage risk and determine if the fund would actually work as intended:

> I think everyone would be saying that, no, $2 billion is probably not sufficient. But I think people are also saying that $2 billion is a really good start. It gives people an opportunity to prove that this concept works. It gives people comfort in the overall scheme. That may see government making such a good return that it will have more funds to be able to continue the process in its own right. But, equally, that frisson, as we spoke about, might see other investors coming into the equation and that $2 billion very quickly becoming $20 billion or more. That's where we see it going. So, yes, I think we'd all like more than $2 billion. But, as Australian taxpayers, we'd probably all be a bit concerned about it being more than $2 billion. But let's give it a go, and hopefully we will see it take off.[7]

1.15 When Treasury were asked similar questions, they stated that it was very difficult to predict how much of a difference the ABSF would make in terms of funding costs and when these benefits might materialise:

> Once again, it's very difficult to come up with answers around the end quantitative impact. When we think about the potential impact on funding costs, there are a number of issues to consider. The first is that, at least in the initial stages of the fund, the AOFM has the capacity to provide funding at a discount rate to the market, so that will be a direct impact on the cost of funding in the market. Over time, if we see the market infrastructure develop, and particularly if we see SME lenders grow and their scale increase, naturally the marginal costs of their business, including the funding costs, will go down as part of that process.[8]

1.16 Labor Senators also note evidence from Treasury officials that the fund is designed to be unwound at some point when this market is at sufficient size and maturity. These criteria have not been set yet:

> For this policy, as I said, success will be a multifaceted thing. We'll have to take a lot of factors into account before we conclude that the policy has been successful. There are formal reviews, as I said, over two and five years to assist that assessment. So there's no target time frame and there's no

6 Mr Peter Langham, *Committee Hansard*, p. 11.

7 Ms Helen Gordon, *Committee Hansard*, p. 23.

8 Mr Warren Tease, *Committee Hansard*, p. 34.

> target quantum on the size of the market to determine when the AOFM will exit. There hasn't been a detailed discussion about the nature of the exit, but the exit process could be as simple as the AOFM ceasing to invest in securities and letting its investments mature.[9]

1.17 Given this evidence, it seems that the Treasurer might have overstated the benefits of the ABSF, especially in the short to medium term.

## Taxpayer risks from the creation of the ABSF

1.18 There are a number of risks that are created by the establishment of the ABSF and tasking of the Australian Office of Financial Management (AOFM), which are outlined below.

1.19 The AOFM, for the first time, will likely be required to buy non-rated securities in parts of the market where they have very limited prior experience. This is in contrast to the AOFM's work in buying residential mortgage backed securities (RMBSs). Stakeholders acknowledged that buying non-rated securities would require considerable due diligence effort and would have impacts on AOFM staffing and outsourcing arrangements.

1.20 The Australian Securitisation Forum stated they believed that the AOFM will have to operate without ratings and that due diligence in these circumstances would be important:

> I think there are ways in which the AOFM can operate, and I think the reality is that in the first few years they will need to be operating largely without ratings from the major credit-rating agencies.
>
> …
>
> They will need to do quite reasonable due diligence on the lender to which they're providing the finance that will be ultimately providing the loans to small businesses, so they will need to understand their credit processes, their underwriting standards and the way in which they're capturing information and managing cash flows from the loans.[10]

1.21 Scottish Pacific indicated that investing in unrated securities would provide a more meaningful contribution to improving SME cost of debt financing and that due diligence was very important in this area:

> But, when you think about it, the people that need the help and the lenders that are going to provide it are going to struggle to get a program rated. You can get all your policies and procedures down pat and get comfortable with them, but, at the end of the day, you've got to make sure that the people running that finance company adhere to all those policies and procedures, and that becomes the challenge. Most ratings I've seen have been done on

9 Mr Warren Tease, *Committee Hansard*, p. 35.

10 Mr Christopher Dalton, *Committee Hansard*, p. 4.

> historical data going back many years. I think that might inhibit the amount of funds you're going to get out the door.[11]

1.22 AFIA stressed that it would be critical for the AOFM to have the right skills if unrated securities were purchased:

> Senator KETTER: Is it your understanding that the AOFM will require all securities bought via the ABSF to be rated?
>
> Mr Thrift: I don't want to comment too closely on that, because I know this has been a strong point of discussion within AOFM at these roundtables. My understanding is that not necessarily you can buy outside of that—again, I don't want to use the terminology 'if the deal makes sense'—if the investment mandate is met. I do note that earlier today Narrow Road talked about this situation. Making sure AOFM has the necessary expertise would be very critical in these types of deals.[12]

1.23 Another risk that presents itself will be that, in the absence of regulation, there will be incentives to lend additional funds to SMEs by lowering loan standards if there is a willing customer in the Commonwealth. Treasury have indicated that they understand this risk and expects that one way to mitigate this risk is to ensure that lenders retain a sufficient size of the first-loss security:

> Additionally, I think there'll be an expectation that the non-bank lender will hold those first-loss securities in its balance sheet to ensure that it retains skin in the game, and therefore to make sure that its credit decisions are as effective as possible.[13]

1.24 Narrow Road Capital indicated that a wave of funding requests could be expected once the ABSF is operational:

> …once this process begins and someone, whether that's managers who are hired for the AOFM or the AOFM itself, hangs out the shingle and says, 'We're open for business,' you will get hit with a wave of emerging lenders looking for finance. That will come straight away, and that's why the number of how much you do in the first 12 or 24 months could be far higher than what's envisaged.[14]

1.25 One issue for the AOFM to manage is where to buy in the capital structure of a securitised fund. One option would be to buy securities in the safer end of the securitised fund, which would reduce risk of taxpayer loss but see a lower rate of return. One issue with this approach is that if there is already enough competition for safer securities, the Commonwealth might not be able to make a meaningful difference in reducing the funding cost in this tranche.

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11 Mr Peter Langham, *Committee Hansard*, p. 13.

12 *Committee Hansard*, p. 24.

13 Mr Warren Tease, *Committee Hansard*, p. 39.

14 Mr Jonathan Rochford, *Committee Hansard*, p. 6.

1.26 An alternative approach would be to purchase riskier securities in mezzanine part of the securitised fund, acknowledging the proposed investment mandate does not allow the AOFM to buy first-loss securities. If there is less competition in this part of the market, the Commonwealth will be able to make a more meaningful difference to reducing the cost of funding, but will take on a larger risk and should be compensated with a higher rate of return.

1.27 The Australian Securitisation Forum acknowledged this issue and stated that the AOFM should have discretion about where in the risk/reward spectrum it might purchase securities and did not rule out purchase of riskier securities:

> Mr Dalton: …The Commonwealth and the AOFM will need to look at various opportunities to decide what's the appropriate risk/reward balance. On some occasions they may be just looking to increase funding with one lender and take a senior position. In another case they may be looking to have a greater impact by taking a mezzanine or a lower position, potentially. I think the market is there for both the higher and lower grade degrees of credit risk, and I think the AOFM is going to need to be aware of where the market is and of the pricing at any point in time. Again, I think they've had the experience in how the market moved and, fortunately, improved for residential mortgage backed securities after the crisis in the original RMBS program.
>
> Senator KETTER: What I'm trying to get at is: if the government is there looking at the safer end of the spectrum and there are plenty of other investors also playing in that space, will the government's involvement make much of a difference to lowering the cost of capital?
>
> Mr Dalton: Potentially. If you've got fewer players, generally they can make the market in terms of the price that they want in terms of providing a loan or purchasing or investing in a security, so I think the fact that the Commonwealth's there as a participant, expressing where they see the risk/reward and the price level to be, can ensure there's some price tension and some competitive tension in the market. I think that aspect will be healthy to help develop a more diverse and competitive market.[15]

1.28 Scottish Pacific indicated that the ABSF should probably operate in the safer end of the market, leaving others more exposed to potential losses:

> Senator KETTER: In terms of the involvement of the AOFM and what part of the risk spectrum they should be involved in, what do you say should happen?
>
> Mr Langham: I think AOFM can work with other lenders and leverage off their expertise. They can therefore have minimal risk and probably minimal expertise within their own organisation, but they can work with people who are going to lose more than the AOFM if this thing goes wrong. I think working with an awful lot of experts and experienced people who are already in the market is a better way to go than building up an internal team.

15 *Committee Hansard*, p. 5.

> Senator KETTER: This then goes to the issue of: if there are other players at that end of the risk spectrum, what does the government's involvement add to the equation?
>
> Mr Langham: My view is that government involvement will encourage more people to look at that space. They may be able to de-risk themselves in terms of their exposure, and eventually they'll be the ones taking the government out of those programs. So it's about getting people comfortable in the early days.[16]

1.29 Narrow Road Capital also indicated that it believed that the ABSF should stick to safer securities:

> The ABSF should therefore look to tread lightly in its intervention in existing markets. This could include working with existing debt capital providers to fund warehouses, with the ABSF sticking to senior positions and letting existing debt capital providers supply mezzanine capital. This approach would also allow the ABSF to benefit from the expertise of existing debt capital providers, as well as limiting the risk of taxpayer funds being lost.[17]

1.30 Pricing the securities will be a key function of the AOFM in administering the ABSF. Given small businesses might be disproportionately impacted harder than larger businesses in an economic downturn[18], there is a significant credit risk that needs to be accounted for and diversification might only have limited benefit at such a time. In addition, it is already acknowledged that this part of the finance sector is underdeveloped and so will have lower levels of liquidity. Should an economic downturn eventuate, any remaining liquidity might reduce substantially. This combination of credit risk, liquidity risk and securities that mature not long after an economic downturn (for instance, Prospa indicated its loans run from six months to two years[19]) might expose the taxpayer to potential loss at a time when the Commonwealth budget might already be under pressure.

1.31 Narrow Road Capital put forward ways to manage these risks but acknowledged money could be lost if there was poor advice:

> Mr Rochford: For the first part of your question, there are ways to control risk within these structures so that losses go from being probable or, if you did it very poorly, even likely to extremely unlikely. If I can give you a very simple analogy: everyone understands that house prices have fallen 10 per cent over the last year or so. If you had lent someone 95 per cent of the value of their house a year ago, that house could be worth less than what they owe you and that is starting to look pretty high risk. If you lent them

16 *Committee Hansard*, p. 147.

17 Narrow Road Capital, *Submission 1*, p. 1.

18 Coroaton, A; Kitao, S; Laiu, S & Sahin, A *Why Small Businesses Were Hit Harder by the Recent Recession*, accessed via https://www.newyorkfed.org/research/current_issues/ci17-4.html

19 Mr Beau Bertoli, *Committee Hansard*, p. 19.

> 50 per cent of the value of their house, you will feel fine. You will be quite comfortable that they can still sell the property if they need to and there will be plenty left over for them after they pay you. In the same way, securitisation structures say, 'Okay, if they've got $100 worth of loans and they want us to lend against that $100 worth of loans, if we lend $70 or $80 then that would probably be low risk. If we lent them $95 out of the $100, that would be getting up into the high-risk category. So what you look to do is say, 'Mr Emerging Lender, can you put some more equity in, and can you also find a mezzanine lender?' That pushes the buffer between a potential loss further and further away. That's what a good risk manager would do. It's a question of getting that buffer a bit bigger, because we know there will be a recession in the future. Economies work in cycles, so that will come. Therefore, we have a strong buffer rather than a small buffer, so it can be managed. I'm sorry, I'm not sure if I've answered the second part of your question.
>
> Senator KETTER: I suppose the second part is answered if the risks are managed in a way that you've suggested. I guess it adds to the fact that we need to get the settings right at the outset, and that the AOFM needs to have that expertise to minimise the risks associated with that.
>
> Mr Rochford: Yes. I'd say it as simply as: if you were badly advised you could lose money; if you're well advised this will be very profitable for the taxpayer.[20]

1.32 Stakeholders were clear that the AOFM would need considerable expertise in administering the ABSF. Narrow Road Capital offered this advice:

> Senator KETTER: … One thing we need to consider with all of this is that there is the risk of taxpayer funds being lost in this exercise.
>
> Mr Rochford: Yes. That really comes down to the quality of the people you hire. If I could use an analogy, it would be that the government is looking at spending up to $2 billion to buy a Formula One team. The choice you have, if you want to look at it one way, is: do you want to spend a million dollars a year to have the guy who's the champion of the local go-kart track as your driver or do you want to spend $2 million a year to have Daniel Ricciardo as your driver? If you pay a little bit more, you will get people who are experts, know what the risk looks like and know how these things can go wrong, and, therefore, how to stop that happening.[21]

1.33 Treasury and AOFM acknowledged these staffing challenges and had already identified priority staffing areas:

> Mr Bath: We've provided for seven full-time-equivalent staff scattered around the office but, in particular, doing credit analysis and due diligence in the short term. It may be longer term that we transform those sorts of roles into what investment managers call a 'manager of managers' role. There is still a requirement to do due diligence, even if you do outsource,

20 *Committee Hansard*, p. 10.

21 *Committee Hansard*, p. 9.

> because you've got to do due diligence on the fund, and there are also checks that need to be done on each investment, because governments have an extra onus to be careful with taxpayers' money that perhaps others might not.
>
> Senator KETTER: What new skills, if any, will be brought into the organisation?
>
> Mr Bath: Credit analysis is the primary one.
>
> Mr Nicholl: That's the key one.
>
> Mr Bath: The key one, yes. It might be that you find us hiring corporate bankers, as opposed to securitisation experts, which was the case last time. The gap that we've got—our being a sovereign debt management agency—is that we don't have a deep amount of expertise in lending to small businesses.[22]

1.34 The AOFM also indicated that outsourcing of some work will likely occur because of difficulties in attracting staff and that some work was highly specialised:

> Mr Bath: ... I think our experience in the RMBS space, which was at the heavily secured end of the spectrum, speaks for itself. We would not have too many concerns about operating at that end of the spectrum. In the unsecured space, it's significantly greater risk to the taxpayer, and we would obviously approach it accordingly. My expectation is that we would hire a significant amount of expertise. We've sought additional resources and received them through the additional estimates process. It may be the case that we head down the path of actually outsourcing some of the investment management activity if we decide that there is a need to do so, because there are very specialist investment management firms who operate in the boutique credit investment space. It's unlikely that we'd be able to cause them to shut up shop and come and work for us in Canberra, so it's more likely that—
>
> CHAIR: It's a beautiful lifestyle!
>
> Mr Bath: Well, it's a good place to raise children, and I can recommend it to people who have children. But, in all seriousness, it's highly likely that we would find ourselves faced with a decision as to whether, particularly for the riskier end of the spectrum, we would be happy to do that ourselves or outsource it. Between those two alternatives, there is always the possibility of getting advice—as in hiring consultants to identify specific risks, to analyse specific risks, to quantify them.[23]

1.35 Labor Senators also asked questions about governance of contractual arrangements for outsourced work. It will important that there is value for money and that incentives are aligned between the Commonwealth and external parties given potential taxpayer losses:

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22 *Committee Hansard*, p. 9.

23 *Committee Hansard*, p. 36.

> Senator KETTER: In the event that we've got some outsourcing happening, I'm interested in what we're looking at in terms of contractual arrangements to make sure that there's proper oversight of the external parties, that they provide value for money and that risk to the taxpayer is minimised. Do you have any views about that?
>
> Mr Nicholl: We'll be working within the Procurement Rules of the Commonwealth. Outside of that, we'll develop our own governance arrangements to ensure that any outsourcing arrangements we enter into will meet our needs. They're things that will be determined in the coming months, once the legislation is passed.[24]

## Conclusion

1.36 Labor has always been the friend of small business and has a strong suite of policies that will enable small businesses to grow and thrive in our economy.

1.37 Labor Senators support this bill. Labor Senators are however concerned that the process for developing the legislation has been rushed and that the Treasurer might have overstated the benefits of the ABSF, especially in the short to medium term. There is also clear evidence that many stakeholders believe that any benefits from the ABSF might take years to materialise and that the benefits might only be modest.

1.38 Labor Senators are also concerned about taxpayer exposure to losses through the operation of the ABSF. The evidence present to the committee indicates that the Commonwealth will be taking on risk without much of a commensurate benefit in terms of lowering the cost of capital for SMEs or a significant return on the government's own investments. Labor Senators will continue to monitor the rollout of the ABSF and ensure that any budget risks are appropriately identified, understood and mitigated.

**Senator Chris Ketter**
**Deputy Chair**

**Senator Jenny McAllister**
**Senator for New South Wales**

24 *Committee Hansard*, p. 10.

# Appendix 1

## Submissions, answers to questions on notice and tabled documents

**Submissions**

1 Narrow Road Capital
2 Bendigo and Adelaide Bank Ltd
3 Australian Securitisation Forum
4 CPA Australia
5 Australian Chamber of Commerce and Industry
6 Australian Finance Industry Association
7 Office of the NSW Small Business Commissioner
8 Prospa
9 Goldfields Money
10 Australian Small Business and Family Enterprise Ombudsman

**Answers to questions on notice**

1 Department of the Treasury: Answer to a question taken on notice at a public hearing in Sydney on 15 March 2019 (received 20 March 2019).

**Tabled documents**

1 Document tabled by Prospa at a public hearing in Sydney on 15 March 2019.

# Appendix 2
## Public hearings

***SYDNEY, 15 MARCH 2019***

**Members in attendance:** Senators Hume and Ketter

BATH, Mr Michael, Head of Global Markets and Business Strategy,

Australian Office of Financial Management

BERTOLI, Mr Beau, Co-founder and Joint CEO, Prospa Advance Pty Ltd

BHAT, Mr Rajesh, Head of Group Capital Management, Prospa Advance Pty Ltd

BRENNAN, Mr Pat, Executive General Manager, Policy and Advice Division, Australian Prudential Regulation Authority

DALTON, Mr Christopher, Chief Executive Officer, Australian Securitisation Forum

FITZGERALD, Ms Anna, Group Head of Corporate Relations, Prospa Advance Pty Ltd

GORDON, Ms Helen, Chief Executive Officer, Australian Finance Industry Association

LANGHAM, Mr Peter, Chief Executive Officer, Scottish Pacific Business Finance

LAWRENCE, Mrs Jill, Acting Director Advocacy, Australian Small Business and Family Enterprise Ombudsman

NICHOLL, Mr Rob, Chief Executive Officer, Australian Office of Financial Management

ROCHFORD, Mr Jonathan, Portfolio Manager, Narrow Road Capital

SQUIRES, Ms Katrina, Senior Manager, Policy and Advice Division, Australian Prudential Regulation Authority

TEASE, Mr Warren, Chief Adviser, Financial System Division, Department of the Treasury

THRIFT, Mr Alex, Associate Director, Policy and Technology, Australian Finance Industry Association