Chapter 2

Business finance and the global financial crisis

2.1 The global financial crisis (GFC) that engulfed the world's economy in 2008 was the 'most serious financial crisis and economic slowdown in decades' (see figure 2.1).[1] Its effects were extraordinary, and the committee emphasises that any discussion of economic conditions and policies, such as in this report, should take its influence into account.

Figure 2.1 The GFC caused a significant global economic contraction[2]

2.2 Australia weathered the GFC far better than most other countries as a result of its fiscal and regulatory strengths. However, it was not immune from its effects, which

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1 G-20 Meeting of Ministers and Governors, Communiqué, 9 November 2008, http://www.g20.org/Documents/2008_communique_saopaulo_brazil.pdf (accessed 30 March 2011).

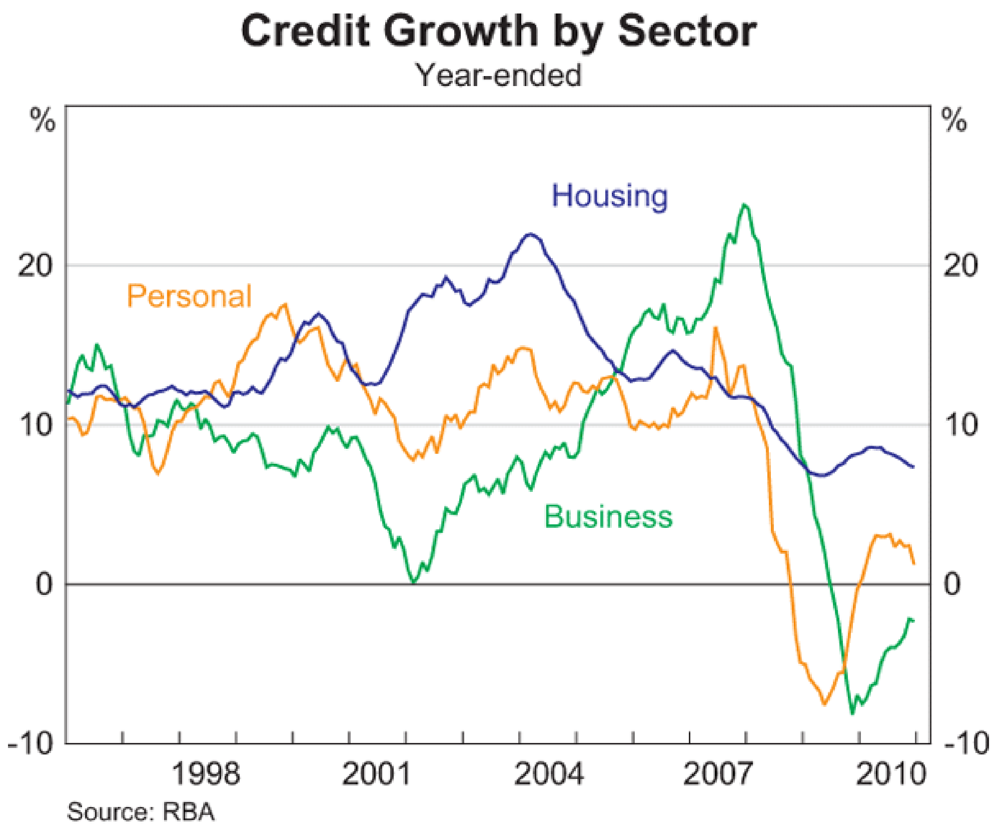
2 RBA, The Australian Economy and Financial Markets, Chart Pack, April 2011, p. 1.

were perhaps nowhere more evident than in access to finance particularly for the SME sector.

The GFC and access to finance

2.3 The GFC saw a massive drop in credit levels for both business and personal lending as well as a more modest slowing of housing finance growth, as figure 2.2, from the Reserve Bank of Australia (RBA), shows.

Figure 2.2 Credit growth by sector, as at March 2011[3]



2.4 Funds available to lenders decreased as a result of the GFC. In the less certain economic environment, the risk appetite of lenders has been reduced. The same is true for the wholesale funders on whom the banks rely.[4] The Australian Finance Conference (AFC) stated that for lenders in Australia the overseas wholesale debt and securitisation markets were inaccessible by the second half of 2008.[5] CPA Australia noted that the GFC caused 'a scarcity of debt funding' and attributed this, in part, to 'a reduction in the number of foreign lenders, changes to the risk profiles of lenders and the increased difficulty of accessing other sources of funding (particularly for larger

3 RBA, The Australian Economy and Financial Markets, Chart Pack, p. 9.

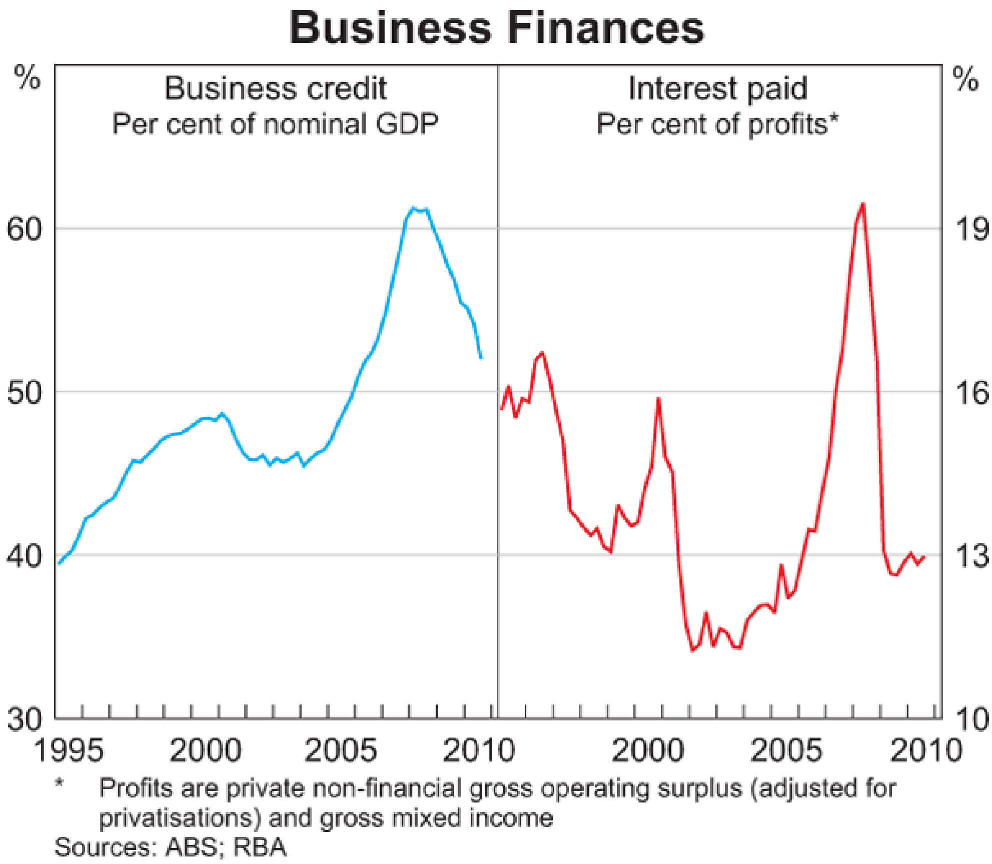
4 RBA *Submission 3*, p. 7.

5 AFC, *Submission 15*, p. 2.

corporates)'.[6] For lenders, the cost of obtaining funds increased. ANZ reported that prior to the crisis the average cost of five-year term funding was 16 basis points above the Bank Bill Swap Rate, while in early 2011 the cost was between 120 and 150 basis points above this rate. This contributed to an 'an absolute increase' in funding costs.[7] Other lenders (such as mutuals) faced the same issues.

2.5 Notwithstanding the dramatic effects of the GFC, business credit levels remain proportionally high. Figure 2.3 shows that, despite the drop in credit caused by the GFC, credit as a percentage of GDP remains higher than at any time in the period 1995 to 2005, while the interest bills faced by business remain low as a proportion of profits.

Figure 2.3 Business finances[8]



2.6 While the GFC saw a decline in business finance, this was not simply a problem with supply. The RBA explained that there have also been significant constraints on demand:

6 CPA Australia, *Submission 10*, p. 1.

7 ANZ, *Submission 14*, p. 11.

8 RBA, The Australian Economy and Financial Markets, Chart Pack, p. 7.

> Business surveys suggest that the availability of finance is not the most significant factor concerning small businesses at present. According to the PwC/East & Partners Business Barometer, the availability of credit appears to have been less of a constraint than it was a year ago. In September 2010, 37 per cent of businesses expected the availability of credit to be a constraint in the year ahead, compared with 82 per cent of businesses surveyed in late 2009. By comparison, in September 2010, around 60 per cent of businesses cited global economic conditions and a general deterioration in confidence as an impediment on business activity. Likewise, the Sensis Business Index and ACCI Small Business Survey suggest that issues such as lack of sales, economic climate and future cash flows are more of a concern for small businesses than the cost and availability of debt financing. NAB's Quarterly SME Business Survey indicates that cash flows, global economic uncertainty and a lack of demand are significant issues facing around 30 per cent of small and medium businesses, while credit conditions remain a concern for around 15 per cent of businesses.[9]

2.7 Thus an important element of the reduction in business borrowing has been reduced business demand for loans. Nevertheless ACCI indicated that businesses are reporting that 'changes in bank lending criteria negatively affected their capital expenditure plans,'[10] and that 'difficulties in obtaining finance may have been worsened by the declining risk assessment skills within the banks.'[11]

Have SMEs been hit hardest?

2.8 The GFC affected all areas of the economy, including small and medium business finance. However, SMEs appear to have fared better than large business. Lending to large business has dropped dramatically since 2007. In contrast, lending to SMEs experienced a more modest decline, and may be showing clearer signs of recovery (Figure 2.4).

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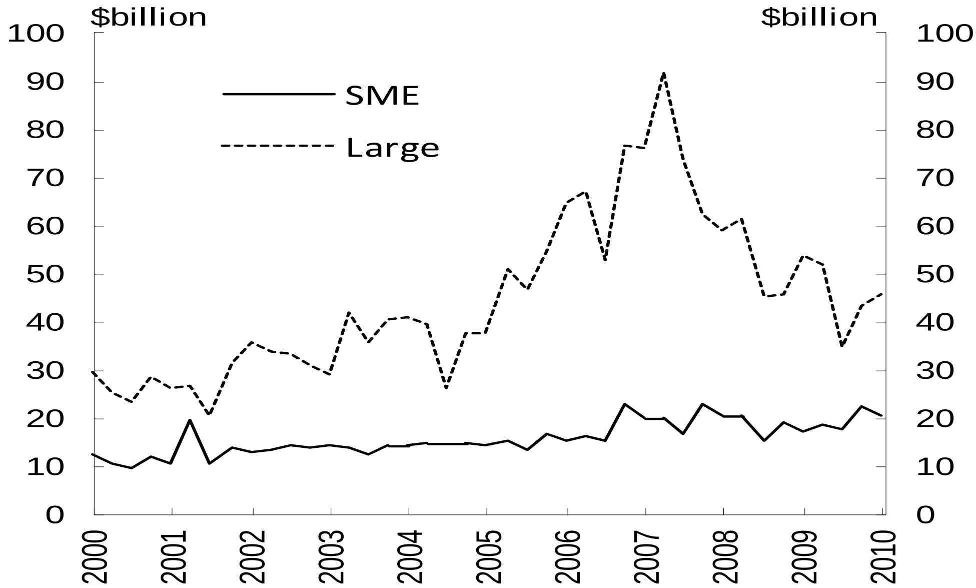
9 RBA, *Submission 3*, pp 3–4.

10 ACCI, *Submission 6*, p. 8.

11 ACCI, *Submission 6*, p. 13.

Figure 2.4 - Bank lending to business[12]



Source: RBA D7 – Bank lending to business, as included in submission from Treasury.

2.9 The RBA reported a slowdown in SME lending following the GFC, attributing this to 'reduced demand from businesses and a general tightening in bank's lending standards.'[13] However, Treasury indicated that new lending to SMEs increased from $19.8 billion per quarter in September 2007 to $20.6 billion per quarter in September 2010.[14] The ANZ noted that lending to SMEs is beginning to increase, reporting that its '[t]otal lending in Small Business Banking has grown strongly since the GFC.'[15]

2.10 As noted above, demand for finance dropped in the wake of the GFC, and this appears as true for SMEs as for large business. CPA Australia's Asia Pacific Small Business Survey, conducted in October 2010, indicated that 'except only in a small number of cases, lending conditions, loan procedures and the cost of finance were not cited as reasons for not applying for finance.'[16] Rather, the majority of businesses indicated that they did not need additional funds.

Nevertheless, the GFC has meant higher costs

2.11 As the AFC noted, credit pricing was influenced by the cost and scarcity of funds available. Treasury reported that finance has become more expensive for

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12 Treasury, *Submission 16*, p. 5.

13 RBA, *Submission 3*, p. 1.

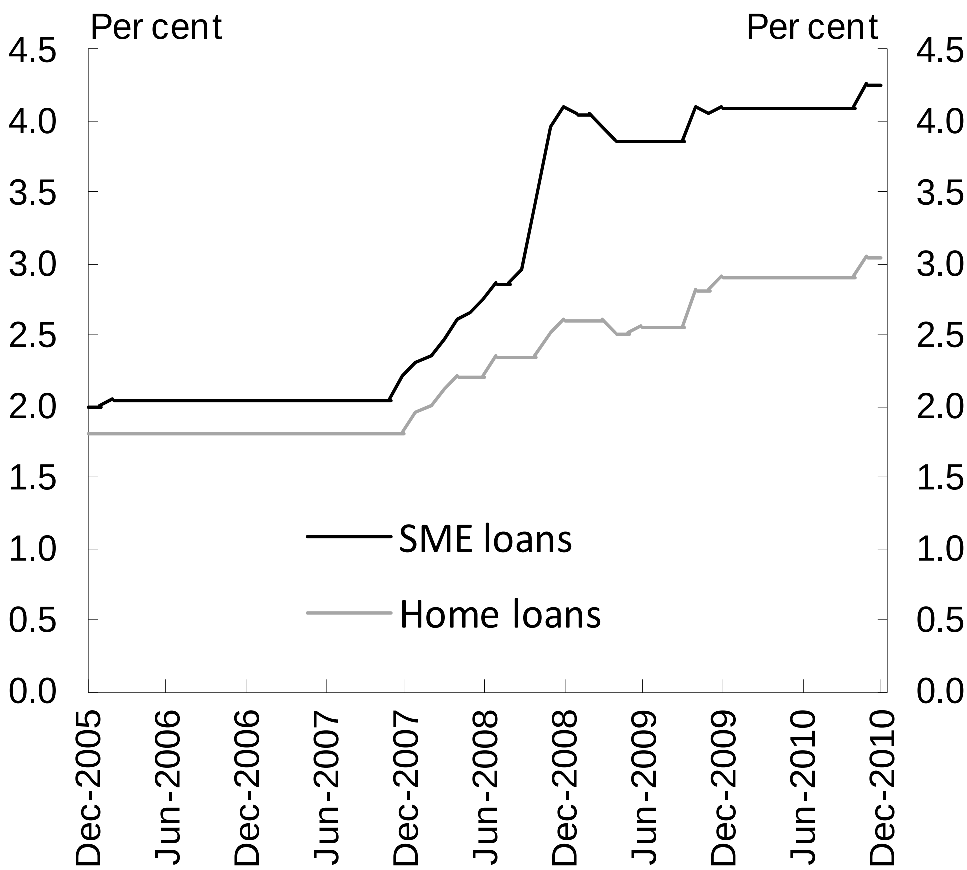
14 Treasury, *Submission 16*, p. 5.

15 ANZ, *Submission 14*, p. 8.

16 CPA Australia, *Submission 10*, p. 3.

SMEs.[17] As figure 2.5 indicates, the margins between the official cash rate and loan interest rates have increased, with the margin for small business loans increasing more than for residential loans. The committee heard concerns from business groups about this, with the NSW Business Chamber noting that '[s]preads on small business loans have blown out from around 200 basis points to more than 400 basis points,'[18] while ACCI submitted that 'the increases in lending rates relative to the cash rate have been much larger for small business loans than housing loans since June 2007.'[19] This matter is further considered in chapter three.

Figure 2.5 – Interest rates compared to the cash rate[20]



Source: RBA F5 – Interest rates, as included in submission from Treasury.

17 Treasury, *Submission 16*, p. 1.

18 NSW Business Chamber, *Submission 8*, p. 1.

19 ACCI, *Submission 6*, p. 1.

20 Treasury, *Submission 16*, p. 8.

2.12 The RBA advised that, as of early 2011, the average residentially secured small business loan interest rate is approximately about 180 basis points above the residentially secured housing loan indicator rate. By comparison, at the start of 2008, the small business rate was approximately 95 basis points above the housing rate.[21] Clearly, the cost of finance is higher than immediately prior to the GFC. However, this does not mean that it is at historically high levels.

The good old days?

2.13 On the basis of information provided, the committee does not believe there will be a swift return to the conditions immediately prior to the GFC. Indeed, such conditions probably were unsustainable across all sectors of the economy. When CPA Australia conducted a round table of finance sector corporations, '[m]any corporates admitted that the easy credit days prior to the GFC led them to drop good business practice.'[22] The Australian Bankers Association (ABA) reported that:

> From the late 1990s till 2007...small businesses generally had sufficient access to bank finance. Due to this high availability of funding and competition, margins were contracting on business lending by around 10 basis points per annum, and the risk premiums being charged reduced. Some found lenders eased their credit standards and non-bank lenders made credit available to segments of the market that were not being served by banks due to their risk profile.[23]

2.14 The ABA's Mr Münchenberg confirmed this view at hearings, saying 'I think we will return to an appropriate equilibrium. The situation before the GFC was exceptional.'[24] As figure 2.2 indicates, business credit growth prior to the GFC was at an historically high level. Figure 2.3 likewise shows that business credit as a percentage of GDP had been rising sharply prior to the GFC and even today remains high. Prior to the GFC the cash rate was at its highest level in a decade.[25]

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21 RBA, *Submission 3*, p. 5.

22 CPA Australia, *Submission 10*, p. 5.

23 ABA, *Submission 13*, pp 1–2.

24 Mr Münchenberg, CEO, ABA, *Proof Committee Hansard*, 4 March 2011, p. 50.

25 Reserve Bank of Australia, The Australian Economy and Financial Markets chart pack, March 2011, http://www.rba.gov.au/chart-pack/pdf/chart-pack.pdf, accessed 30 March 2011.

Conclusion

2.15 The OECD has characterised the GFC as 'the severest financial crisis in decades' to affect the global economy.[26] According to the OECD, '[t]he Australian economy has been one of the most resilient in the OECD during the global economic and financial crisis.'[27] This view is shared by Australian stakeholders, for example, RBA Deputy Governor Ric Battellino recently noted that 'no other developed economy has experienced uninterrupted growth over the past 20 years', a comment that includes the period since the onset of the GFC.[28]

2.16 The small and medium business sector has made a significant contribution to this resilience, and this has been reflected in stable borrowing levels. The ABA submitted that 'growth in small business lending...has held up better than the wider business lending market over the last 12 months.'[29]

2.17 Nevertheless, the committee recognises that there have been some specific issues in SME finance, in relation to prudential requirements and competition, and it is to these the committee now turns.

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26 OECD, *OECD strategic response to the financial and economic crisis: Contributions to the global effort*, 2009, p. 3.

27 OECD, *OECD Economic Surveys, Australia: Volume 2010/21, Supplement 3*, November 2010, p. 8.

28 Ric Battellino, 'Twenty Years of Economic Growth', *RBA Bulletin*, September 2010, p. 103.

29 ABA, *Submission 13*, p. 3.