Chapter 3

Causes of the slowdown in small business finance

Introduction

3.1 The previous chapter showed that, since the global financial crisis, there has been a marked slowing in the provision of credit to small businesses in Australia. Assessing whether there is a widespread or systemic 'credit crunch' applying to small business finance is quite complicated, as there are a myriad of simultaneous influences (In economic jargon, there is an identification problem, with movements both of and along the demand and supply curves.)

3.2 The slowdown in lending to small business appears to reflect a combination of demand factors such as;

- less demand for finance by small business in the wake of the global recession, as weaker sales mean that existing capacity is adequate and there is not the need to borrow for investment;
- less demand for finance by small business as reduced confidence leads to a more conservative attitude towards debt;

and supply factors such as;

- fewer small businesses being able to meet existing lending standards in the wake of the global recession;
- some tightening of lending standards by financial intermediaries. It is arguable that banks were tending towards recklessness in the preceding boom, and that some tightening of credit standards represents a prudent return to 'normal' practice, but there may also be cases where banks are over-reacting; and
- non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive.

3.3 Witnesses and submitters were hesitant to apportion the credit slowdown between demand and supply influences. For example, the Reserve Bank concluded:

> Lending to small businesses has been little changed over 2009, after growing steadily over prior years. The slowdown reflects both reduced demand from small businesses and a general tightening in banks’ lending standards. Small businesses in most industries have been able to access

> funding throughout the financial crisis, albeit on less favourable terms than previously.[1]
>
> We think the slowdown in lending reflected both supply and demand factors. On the demand side…there was reduced demand reflecting the state of the economic cycle. On the supply side there was a general tightening in banks' lending standards. Nevertheless, as we have said in our submission, our assessment is that small businesses in most industries have been able to access funding through the financial crisis, albeit on less favourable terms than they were previously.[2]

3.4 The prudential regulator's perspective is that banks are not singling out small business for reductions in credit:

> …we do not see that the banks are treating small business differently from how they are treating other clients.[3]

3.5 They were also agnostic about the relative importance of demand and supply factors:

> …there were two elements—a demand impact and a supply impact. I do not really know which one dominated.[4]

3.6 Treasury also referred to both demand and supply factors without indicating which predominated:

> On the demand side, businesses have been deleveraging to strengthen their balance sheets and have cut back their investment plans in line with global economic weakness. On the supply side, banks have faced higher funding costs due to the global repricing of risk and have also raised their assessment of small business risk, reflecting the point in the economic cycle.[5]

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1 Reserve Bank of Australia, *Submission 2*, p. 1.

2 Dr Guy Debelle, Assistant Governor, Reserve Bank of Australia, *Committee Hansard*, 12 April 2010, p. 18.

3 Mr Keith Chapman, Australian Prudential Regulation Authority, *Committee Hansard*, 12 April 2010, p. 57.

4 Mr Graham Johnson, Australian Prudential Regulation Authority, *Committee Hansard*, 12 April 2010, p. 57.

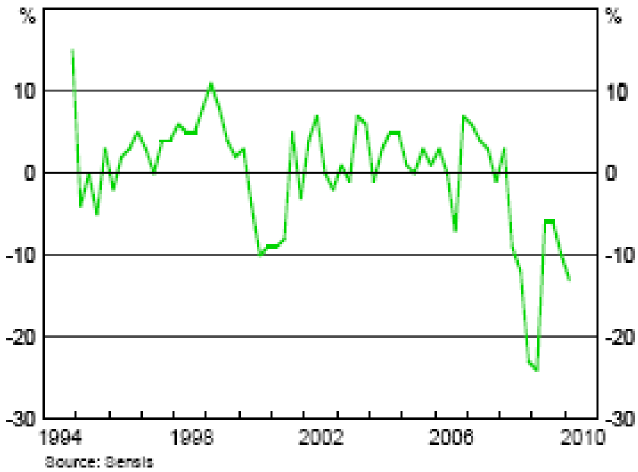
5 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Proof Committee Hansard*, 10 May 2010, p. 2.

Demand for credit by small business

3.7 On the demand side, the Reserve Bank note that small business has scaled back investment plans (Chart 3.1).

Chart 3.1: Small business investment expectations

Net balance: deviation from long-run average



Source: Reserve Bank of Australia, *Submission 2*, p. 3.

3.8 Similarly, APRA noted:

> …the smaller end had a fall-off in their approach to the banks and other lenders for loans.[6]

3.9 The banks referred to a reduction in demand for credit:

> …we saw demand, particularly in the September quarter of 2008, start to contract quite markedly. It is pretty fair to say that since that time credit demand in this area has been flat…[7]

> Since the beginning of the global economic crisis, overall lending to business has been subdued both at ANZ and other lenders. This primarily reflects a fall in loan application numbers due to reduced demand for credit in uncertain times and to a lesser extent a tightening in credit criteria.[8]

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6 Mr Graham Johnson, Australian Prudential Regulation Authority, *Committee Hansard*, 12 April 2010, p. 57.

7 Mr James Tate, Chief Product Officer, Westpac Banking Corporation, *Committee Hansard*, 12 April 2010, p. 69.

8 ANZ Bank, *Submission 40*, p. 3.

Supply of credit to small business

3.10 On the supply side, APRA observe:

> On the supply side, after something like the global financial crisis, the increase in arrears rates and non-performing loans, the authorised deposit-taking institutions and other lenders actually tightened up their lending terms, as would be expected after something like the global financial crisis. The ADIs did things like reducing the maximum loan they would give to particular classes of borrower, they lowered maximum loan to valuation ratios, had higher interest coverage ratios—those sorts of things—to tighten up their terms, with more stringent covenants, and hence there was a drop-off in the available supply.[9]

3.11 Similarly,the Reserve Bank note:

> Small business borrowers have faced lower loan-to-valuation ratios, stricter collateral requirements and higher interest coverage ratios.[10]

3.12 This conclusion is supported by CPA Australia. A survey of their members concluded:

> The banks are still lending but mostly where the loan is fully secured by a tangible asset and personal guarantees (and in some cases, also key man insurance). Where there is an existing loan, banks are requiring additional security. In summary, members stated that lenders were no longer prepared to provide finance on ‘soft’ security such as cash flow or goodwill (unsecured finance) - which had been available pre-GFC.[11]

3.13 This reflects the increase in non-performing business loans in recent years. As the bankers put it:

> Banks were right to look at business, in particular small business which is inherently more risky, as a source of potential increases in bad debts. The number of business loans that are 90-days plus in arrears or over three months outstanding has increased significantly over that time, which underlines the fact that the banks were right to see this as being a riskier area of lending.[12]

3.14 The bankers contrasted the risks in business lending compared with home lending:

> That figure is seven times higher than what home lending is, so to compare it with home lending, which is a relatively safe and secure form of lending,

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9 Mr Graham Johnson, Australian Prudential Regulation Authority, *Committee Hansard*, 12 April 2010, p. 57.

10 Reserve Bank of Australia, *Submission 2*, p. 3.

11 CPA Australia, *Submission 46*, p. 5.

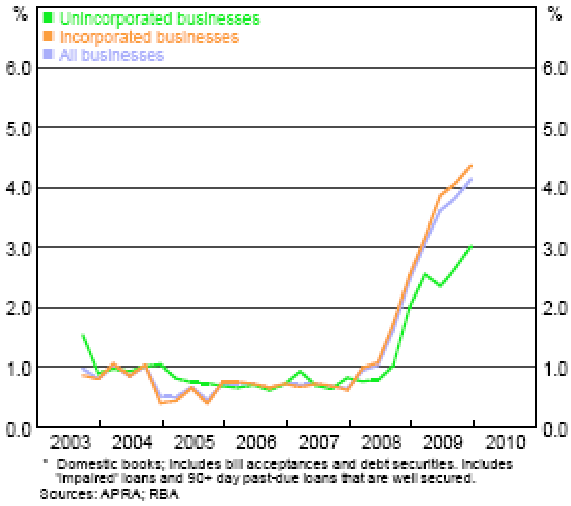
12 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 2.

> business lending is less safe and banks have been right during the economic times to make sure that they are lending appropriately.[13]

3.15 While Chart 3.2 suggests the increase in non-performing business loans may have been smaller for small business than for larger firms, it has been significant for both.

Chart 3.2: Banks' non-performing business assets

Share of outstanding lending



Source: Reserve Bank of Australia, *Submission 2*, p. 5.

3.16 Chart 3.2 refers to the aggregate of all banks. The Commonwealth Bank told the Committee that:

> Pre, post and during the GFC we have not seen any significant change in the credit quality of our book, nor the rate of arrears and the number of people that we pass on a monthly basis to what we call our credit services—businesses that are struggling go across to that unit first off—has not changed at all over the last two years.[14]

3.17 The National Australia Bank reported fewer bad debts among small than larger businesses:

> Senator XENOPHON—In your submission you said that the $13 billion in bad and doubtful debt that the bank reported in 2009 was largely from its

13 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 3.

14 Mr Brewis-Weston, Commonwealth Bank of Australia, *Committee Hansard*, 12 April 2010, p. 105.

business lending activities. How much of that was related to small businesses…?

Mr Healy—The bulk of that would be mid sized and larger businesses, rather than small businesses…Small businesses were helped last year by the government stimulus, which helped many segments of the small-business market. Whilst I do not have the exact figures, the majority of that would have been geared more towards mid sized and larger companies.[15]

3.18 One view is that the tightening in the supply of credit is an appropriate return to more prudent behaviour after excesses of the recent boom:

> Prior to the GFC the spreads on lending were probably the lowest they had been for the statistics that had been collected. There had been 15 years of economic good times, and non-performing loans were at historical lows. I think there was a movement towards lending perhaps without the risk based pricing that should have really been there just prior to the GFC hitting, and then there was some correction after that.[16]
>
> …one of the factors about the global financial crisis is that people reacquainted themselves with the discipline around ensuring that lending was properly priced for risk.[17]

3.19 Other submitters assert that the banks have over-reacted and excessively restricted access to small business finance.[18] There is concern that some good small businesses are being denied funding:

> Senator BUSHBY—…are there small businesses out there that are quite capable of meeting loan repayments and who maybe even have a demonstrated history of being able to meet loan repayments but who are now finding themselves unable to secure finance either to continue or to expand on the basis of decisions that banks have made to raise the bar in terms of lending criteria?
>
> Dr Burn—We fear that that is the case. We do not have any direct evidence about that.[19]

3.20 On the other hand, Westpac's interpretation is as follows:

> …our approximate one per cent decline in business lending in that year was in line with system lending. Analysis of this data highlights that much of this decline was demand-driven and symptomatic of cyclical economic

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15 Mr Joseph Healy, Group Executive, Business Banking, National Australia Bank, *Proof Committee Hansard*, 10 May 2010, p. 26.

16 Mr Graham Johnson, Australian Prudential Regulation Authority, *Committee Hansard*, 12 April 2010, p. 58.

17 Mr Healy, National Australia Bank, *Proof Committee Hansard*, 10 May 2010, p. 25.

18 Mr Suryan Chandrasegaran, *Submission 3*, p. 1.

19 Dr Peter Burn, Director of Public Policy, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 54.

> conditions. In Westpac's view, the decline in lending is a result of a combination of factors; business customers prudently paying down debt, thereby reducing their gearing, and an increase in applications falling short of underwriting standards. The latter is supported by an increase in credit bureau default rates for customers applying for credit. This implies a higher proportion of SME customers applying for credit have a greater risk of defaulting on their debt… Westpac's rate of overriding adverse credit bureau decisions has remained steady in order to support more SME borrowers and overall approval rates have remained high at above 85%...during the past 18 months, Westpac has made no major changes to key SME credit policies relating to debt service cover, interest cover, Loan-to-Value-Ratios (excluding commercial property) or other credit policies…[20]

3.21 The Australian Bankers' Association emphasised that:

> …banks need small business to be doing well for banks themselves to be doing well.[21]

3.22 They did concede, however, there had been some tightening of supply of credit, referring to:

> …changes that banks have reasonably and prudently made in their approach to lending through the course of the global financial crisis…banks have taken a more stringent approach to lending. There is no doubt about that. [22]

3.23 The Australian Bankers' Association argued though that reported instances of undue tightening of credit were rare not typical:

> There will always be businesses, for some reason or another, that are finding it difficult to get credit, or to get credit on the terms that they previously had or the terms that they want. Where opportunities are provided for small business to come forward with specific examples these examples exist, but they tend to be a small number. The government's own clearing house, Hotline for Small Business, has attracted less than 100 calls in the time that it has been set up since March last year, just over 12 months…we need to be careful to extrapolate that to suggest that there are some system-wide issues.[23]

3.24 The reduction in supply of credit is more dramatic from non-ADI lenders. As the bankers put it:

> …there were businesses prior to the financial crisis that were only able to raise money because money was dirt cheap and because there were a lot of

20 Westpac, *Submission 31*, p. 2.

21 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 1.

22 Mr Münchenberg, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, pp 1-2.

23 Mr Münchenberg, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 4.

> people out there who were providing money on very limited risk analysis. When those elements have been removed then obviously there is going to be a tightening.[24]

3.25 The banks referred to having:

> …picked up a lot of customers from lenders who are no longer operating because of changes in credit markets.[25]

The impact of Basel capital requirements

3.26 Bank supervisors from around the world, meeting at the Bank for International Settlements in Basel, have agreed on rules governing capital requirements for banks which APRA implement in Australia. Some witnesses believe that these rules could discourage lending to small businesses as more capital is required to be held against small business loans than for home loans:

> Several commentators have pointed to Basel II regulatory capital requirements as a factor leading to higher costs for small business and a skewing away from business lending as under Basel II banks have to provide a higher level of capital reserves for business loans.[26]
>
> Prima facie, Basel II makes it more attractive for a bank to lend to the household sector than to small business. In fact, we have the perverse situation where it is more attractive to lend for a weekend holiday home than to a small business…there is more capital involved in supporting small business lending as distinct from household lending, and that creates a bias.[27]

3.27 APRA responded:

> It is feasible in certain circumstances that some loans could have quite significantly higher capital requirements and it would look, to somebody looking at the underlying security of that loan, as if they were the same. I will take small business as an example, and one that is secured against a residential mortgage as opposed to an owner occupier buying their house. The risk profile is quite different, as I am sure some of the submissions have indicated. The underlying default rates and arrears rates on owner occupied homes and investor lending is a lot lower than it is for small and medium sized enterprise loans that are secured against the residential mortgage. They have a far higher likelihood of what they call 'probability of default rates' and 'loss given default' than do the normal residential mortgages. Basel II, as a whole, is intended to be risk based, so it actually ensures that the capital that is being held is commensurate with the risk of the loan, and that is whether it is a low-doc mortgage loan, an owner

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24 Mr Münchenberg, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 11.

25 Mr Münchenberg, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 1.

26 NARGA, *Submission 29*, p. 4.

27 Mr Healy, National Australia Bank, *Proof Committee Hansard*, 10 May 2010, p. 23.

> occupier through to a large corporate loan that is unsecured; it differentiates the security and basically has capital according to the underlying risk profile. By itself it is attempting to be a better way of ensuring proper capital is held for the risk faced. That may mean that you do have differences according to sector because of the nature of the business, the risks in the business, the nature of the security and that sort of thing…There are two forms of the capital regime. One is what we call standardised, which is for basically the non-model users, the smaller authorised deposit-taking institutions and banks have not got approval to use an APRA model. We basically specify what risk weights you use. For example, if you have an SME or a corporate loan that is unsecured it would be 100 per cent risk weight—$8 capital per $100 of loan. The larger banks have their own models, which we have accredited over a lengthy process for them to get their Basel II accreditation. Those models use historical data to determine the probability of default and loss given default, on all the various portfolios and generates a capital outcome commensurate with the risk. We have to approve that. We monitor it closely. We compare those banks with their peers. Yes, it will give potentially differential rates for the model users as opposed to the standardised users, but that reflects the fact that the more complicated models are supposed to be better at predicting the underlying risk.[28]

3.28 Since the global financial crisis there have been proposals for further increases in capital requirements. Quantitiative impact studies are currently underway to develop these proposals.[29]

Non-bank lenders

3.29 Small business was hurt by the impact on non-bank lenders of the global financial crisis:

> Incidentally, many small businesses had relied upon non-bank financial institutions, regional banks and foreign banks for access to credit. With the onslaught of the crisis, that segment of the banking system shrank significantly and reduced capacity. They made it clear to some small businesses that, when there facilities were due for renewal, they would be instructing them to seek other forms of borrowing.[30]

3.30 The reduced role of non-bank lenders is discussed further in Chapter 5.

Business liasion by official agencies

3.31 The Reserve Bank's own interreactions with small business led them to conclude:

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28 Mr Graham Johnson, APRA, *Committee Hansard*, 12 April 2010, pp 58-59.

29 APRA, *Committee Hansard*, 12 April 2010, pp 66-67.

30 Mr Healy, National Australia Bank, *Proof Committee Hansard*, 10 May 2010, p. 25.

> …liaison by the Reserve Bank, including through its Small Business Panel, suggest that small businesses in most industries have had tighter but still reasonable access to funds throughout the financial crisis, with property companies being a notable exception.[31]

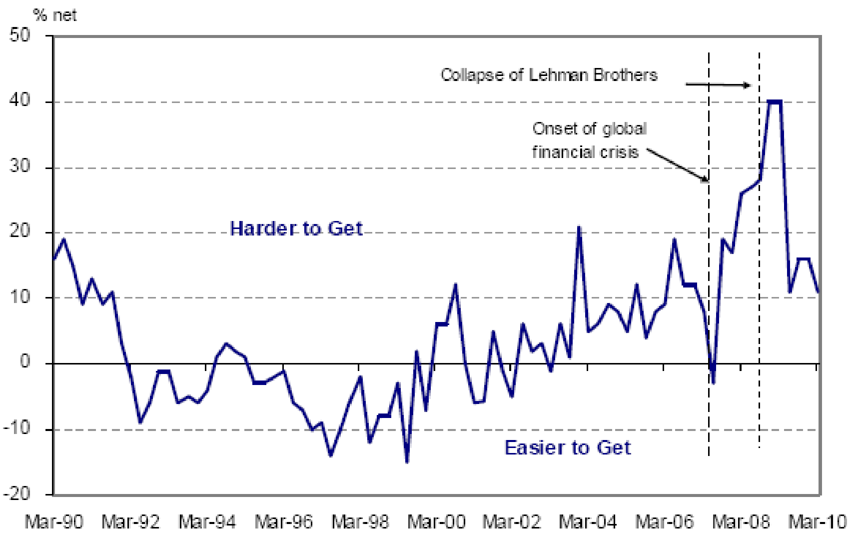
3.32 Treasury also talk to small business as part of their business liaison programme. They summarised recent discussions as:

> Smaller to medium-sized firms appeared generally able to access bank credit, but could be deferring expenditure and continuing their deleveraging until economic and financial conditions become more favorable.[32]

Business surveys

3.33 Another indication comes from surveys of businesses. The long-running Westpac-ACCI Survey – admittedly a survey of businesses in general rather than specifically small business – indicates that while financial conditions are at 'tighter than average levels', they are much improved from early 2009 (Chart 3.3) and only 5 per cent of firms nominated finance as the factor most limiting expansion.[33]

Chart 3.3: ACCI survey – availability of finance



Source: ACCI, *Submission 32*, p. 17.

3.34 A specific ACCI survey found that a quarter of businesses reported that changes in bank lending criteria had led them to revise down capital expenditure plans.[34] Another ACCI survey asks companies what are the main constraints on their

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31 Reserve Bank of Australia, *Submission 2*, p. 3.

32 Treasury, 'Key themes from Treasury's business liaison program', *Economic Roundup*, issue 4, 2009, p. 53.

33 *Westpac-ACCI Survey of Industrial Trends*, March quarter 2010; ACCI, *Submission 32*, p. 17.

34 ACCI, *Submission 32*, p. 16.

investment. Taxes, regulations, labour costs and insufficient demand are all judged more important than credit-related factors.[35]

3.35 Sensis' March 2010 survey of small business found that:

> …20 per cent of businesses reported it was currently relatively easy to access finance; compared to 35 per cent reporting they felt it was relatively difficult, and the remainder feeling that current lending conditions were fairly normal.[36]

3.36 The Deloitte survey of chief financial officers in late 2009 found that 80 per cent them regarded credit as costly but they were evenly divided on its availability.[37] A survey by the Chamber of Commerce and Industry of Western Australia found that a quarter of small business respondents rated borrowing costs among the top three issues affecting them.[38] A Telstra-sponsored survey of small business found that 6 per cent regarded the availability of finance as their major concern while 38 per cent regarded its cost as their major concern.[39] A survey of real estate agencies found that three-quarters felt that access to finance was more difficult than before the global financial crisis and four-fifths believe lending conditions are stricter.[40] Another survey found that 'over 77 percent of retailers are concerned or very concerned about current difficulty in accessing finance'.[41] A survey of residential builders found that 75 per cent faced greater difficulty obtaining finance than was the case before the global financial crisis.[42]

3.37 The Australian Industry Group told the Committee that around a quarter of respondents (both large and small firms) to a recent survey it conducted identified the availability of credit as a negative influence.[43] For small businesses, this was slightly lower than the proportion in 2009.

3.38 A survey of such surveys by the Reserve Bank suggested to them that:

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35 *ACCI Survey of Investor Confidence*, January 2010. The credit-related factors are 'charges by lending institutions' (ranked 7th most important), 'insufficient retained earnings' which arguably implies inadequate external financing (9th) and 'level of interest rates' (10th).

36 Sensis, *Submission 25*, p. 2. The finance industry found it particularly difficult.

37 Australian Industry Group, *Submission 14*, p. 5.

38 WA Small Enterprise Network, *Submission 18*, p. 3.

39 Australian Industry Group, *Submission 14*, p. 6.

40 Real Estate Institute of Australia, *Submission 37*, p. 5.

41 Australian Retailers' Association, *Submission 45*, p. 9.

42 Mr Wolfe, Chief Executive, Housing Industry Association, *Proof Committee Hansard*, 10 May 2010, p. 43.

43 Dr Peter Burn, Director of Public Policy, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 43.

> Small business surveys provide mixed evidence on the availability of finance. Some business surveys, such as the PwC/East & Partners Business Barometer and the ACCI Small Business Survey, suggest that over the past year the availability and cost of intermediated debt has been a constraint on small businesses. However, others, such as the Sensis Business Index and the NAB SME Survey suggest that the cost and availability of debt financing is a concern for relatively few small businesses, with issues such as lack of sales, future cash flow and the economic climate being more important.[44]

Comments by business organisations

3.39 The cost and availability of finance was described by the general council of ACCI as:

> …the most significant day-to-day issue facing Australia's businesses.[45]

3.40 Similarly, the Council of Small Business of Australia described the cost of credit as:

> …the No. 1 issue for small businesses in Australia.[46]

3.41 Turning to individual sectors, the Housing Industry Association opined that:

> The lack of access to finance for residential development is restraining the supply of new housing across Australia… banks are rationing credit to small residential developers, placing an enormous pressure on their cash flow, while at the same time banks are extending a 'normal' stream of credit to households in the form of mortgages.[47]

3.42 Three-quarters of their members reported greater difficulty in attracting finance than before the global financial crisis.[48]

3.43 Similarly, when the Real Estate Institute of Australia surveyed their members:

> …three-quarters of respondents felt that access to finance was more difficult than it was before the global financial crisis. This was despite the

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44 Reserve Bank of Australia, *Submission 2*, p. 3.

45 Mr Peter Anderson, Chief Executive, ACCI, *Proof Committee Hansard*, 10 May 2010, p. 9. The general council comprises the presidents and chief executives of the major chambers of commerce from every state and territory, together with 26 industry associations.

46 Ms Jaye Radisich, Chief Executive Officer, Council of Small Business of Australia, *Proof Committee Hansard*, 10 May 2010, p. 73.

47 Housing Industry Association, *Submission 7*, p. 1. See also their chief executive's evidence, *Proof Committee Hansard*, 10 May 2010.

48 Housing Industry Association, *Submission 7*, p. 13. The submission includes more detailed results from the member survey.

> fact that two-thirds of respondents felt that their financial position was either the same or better than it was 12 months earlier.[49]

Obtaining better information

3.44 The Australian Securities and Investments Commission has a suggestion that may improve information on this topic:

> Currently, Australia does not have a dedicated senior loan officer survey to determine the supply and demand conditions prevailing in the small and medium-sized enterprise (SME) lending market. Such lending surveys currently exist in a number of countries including the United States of America (US), the United Kingdom, Europe and Japan, and have been useful in researching the lending demand and supply dynamics for both SMEs and large firms. For example, the US Federal Reserve issues the 'Senior Loan Officer Opinion Survey on Bank Lending Practices'.[50]

Demographic factors

3.45 The retirement of the baby boomer generation may generate an increase in demand for small business finance. Dr Seet and Dr Graves from the University of Adelaide submitted that:

> …it is anticipated that around 60% of family business owners plan to retire by 2016. Although the majority of family firms intend to pass the business onto the next generation, it is predicted that half will be unable to do so due to a lack of available and / or suitable successors. As a consequence, many family owners will have little option but to sell or close down the business. The scale of this problem suggests that not all family business owners can look forward to traditional exit options such as trade sales, and therefore alternative succession strategies, such as the involvement of PE [private equity], need to be considered. The successful ownership transition of family firms (e.g. to next generation, management buy-out or sale) is critical to the Australian economy as it is estimated that a successful transfer conserves, on average, five jobs, whereas a start-up generates on average two jobs.[51]

3.46 The authors warn, however, that private equity is reluctant to invest in small business and small business is distrustful or ignorant of private equity investors. This makes the role of lenders in facilitating the transfers of small business all the more important.

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49 Mr Jock Kreitals, Manager, Policy, Real Estate Institute of Australia, *Proof Committee Hansard*, 10 May 2010, p. 42.

50 Australian Securities and Investments Commission, *Submission 17*, p. 6.

51 Dr Pi-Shen Seet and Dr Chris Graves, *Submission 48*, p. 2.

The outlook

3.47 Treasury were confident that lending to small business would pick up in due course:

> Going forward, it is anticipated that conditions will improve as the economy recovers and global funding markets re-establish themselves. Investment is expected to recover, risk margins are likely to fall and some lenders that have been forced to scale back their activities as a result of the crisis will be in a position to re-enter the market.[52]

52 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Proof Committee Hansard*, 10 May 2010, p. 2.