NSW Business Chamber

Small Business Access to Finance

Submission to the Senate Economics Committee 1 April 2010

Invigorating Business Representation

Executive Summary

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

The roughly 2 million small businesses in Australia make a very significant contribution to the Australian economy, representing over a third of total industry value added and more than half of all private sector employment. Access to finance is an issue of significant concern for many of these small businesses. The NSW Business Chamber's latest *Business Conditions Survey* found that 29 per cent of small business respondents said that ease of access to finance had deteriorated over the past three months, and only 4 per cent expected that conditions would improve over the next three months.

The global financial crisis has had a significant impact on conditions in small business financing. A combination of accommodative monetary policy, flexible labour markets and fiscal stimulus helped to cushion Australia from the worst of the global downturn, and Australian banks performed more strongly than international banks over this period.

However, while the profitability of the banking sector as a whole has held up to some extent, what has become apparent in the Australian market is that the global financial crisis has allowed the major banks to improve their market share and profitability at the expense of smaller banks and financial institutions.

The reduction in competition in the banking sector has been partly responsible for the increase in interest margins and has made it easier for the banks to shift greater amounts of risk off their balance sheets through stricter lending requirements, such as higher levels of collateral.

Spreads on small business loans have blown out from around 200 basis points to more than 400 basis points, and remain at this high despite the improvement in the global and domestic outlook over the last six months.

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

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

In this environment, it is important that the Government is proactive in fostering the ability of these small businesses to operate and grow.

The NSW Business Chamber makes the following recommendations to both facilitate increased competition and ensure that existing levels of competition are not further eroded.

Recommendation 1: The Government should continue to remain open to new market entrants, both domestic and foreign, as a means of reinvigorating competition within this sector.

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

Recommendation 2: Further mergers within the banking sector should be considered very carefully, and the impact of such mergers on competition in the market must be acknowledged.

The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. Mergers reduce competitive pressures in the banking sector. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further mergers should be carefully considered and their impact on competition acknowledged.

Recommendation 3: Consideration should also be given to new measures to increase competition in small business lending.

In 2008, the Government acknowledged that greater competition was needed in the household mortgage sector, and implemented a range of measures to address this issue by reducing barriers to switching providers. The introduction of similar measures targeting small business lenders may be appropriate. In particular, an open Productivity Commission review of the costs and constraints faced by small businesses in attracting finance could give this issue greater prominence, and assist in promoting competitive pressures within this part of the banking sector.

Recommendation 4: The Government should put greater pressure on banks to keep small business lending rates down, and publicise good and poor performance in this area by individual banks.

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

Recommendation 5: Consideration should be given to the implementation of a guarantee of small business loans in Australia, taking into consideration the principles outlined below.

The implementation of an appropriately priced government guarantee is an effective way of rejuvenating the flow of finance to productive parts of the economy and can be self-funded.

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

- **There needs to be a price charged for the guarantee.** Charging a price protects the Government's financial position, and ensures that it is appropriately compensated for the risk transferred to its balance sheet. Providing a price signal also means that use of the guarantee should naturally wind down over time as market conditions return to more normal levels over the medium-term.
- **Banks should remain responsible for the financial assessment of small business applicants.** Bank assessment of the loans will ensure that applications still have to meet minimum standards in order to be eligible for the guarantee. In this way, the risk of defaults, and the Government guarantee being utilised, are minimised.
- **The guarantee should not cover 100 per cent of the loan.** In order to avoid moral hazard issues, it is important that banks still have a financial incentive to carefully consider loan applications. Similar guarantees in other countries tend to cover between 75 and 85 per cent of the loan.
- **The guarantee should not be capped, and should be available to the entire small business sector.** While the scheme would only be eligible to individual loans below a certain threshold, for the scheme to be effective and to avoid rationing of finance, it is important that the total amount the Government is willing to guarantee is uncapped.

The Importance of Small Business Finance

Characteristics of the small business sector

The NSW Business Chamber supports the Senate's decision to set up an inquiry to examine the issue of small business access to finance. Small businesses (defined by the ABS as those employing less than 20 people[1]), make a very significant contribution to the Australian economy.

As at June 2007, there were approximately 1.93 million active small businesses in Australia, representing around 96 per cent of all Australian businesses.[2] Over the four year period between June 2003 and June 2007, the number of small businesses grew by around 7½ per cent.[3] Assuming that this growth rate has continued since June 2007, it is estimated that there are currently more than 2 million active small businesses in Australia.

Small businesses make a significant contribution to employment. Over 750,000 small businesses employed staff in June 2007, and the number of employing small businesses grew by around 37 per cent over the four year period since June 2003.[4] Small businesses employed 5.1 million people at the end of June 2008, representing more than half of all private sector employment, (10.0 million at June 2008).[5]

Small businesses contributed over $300 billion to industry value added in 2007-08, representing over a third of total industry value added ($771 billion in 2007-08).[6] Approximately 17,000 small businesses exported goods in 2007-08, representing 39 per cent of all exporters.[7]

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

Importance of the issue

Access to finance is an issue of significant concern to small businesses. The NSW Business Chamber conducts a quarterly Business Conditions Survey which, among other things, gathers data from businesses on both access to finance and the cost of finance. The latest survey (March 2010),[8] found that 29 per cent of small business respondents said that ease of access to finance had deteriorated over the past three months, and only 4 per cent expected that conditions would improve over the next three months.

In addition, 44 per cent of small business respondents reported that the cost of finance had increased over the past three months, while only 3 per cent reported that the cost of finance had fallen. Expectations were for further increases in the cost of finance over the next three months.

A recent survey conducted by the Council of Small Business of Australia (COSBOA),[9] found that 81 per cent of small businesses were concerned about higher interest rates, 74 per cent were concerned about the cost of finance and 64 per cent were concerned about the availability of finance. When asked to list their single biggest concern, nearly half of all respondents identified finance related issues (either the costs of finance, access to finance or interest rates).

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

2 Australian Bureau of Statistics, *8165.0 Counts of Australian Businesses,* 2007

3 Ibid.

4 Ibid.

5 Australian Bureau of Statistics, *8155.0 Australian Industry,* 2007-08

6 Ibid.

7 Australian Bureau of Statistics, *5368.0.55.006 Characteristics of Australian Exporters,* 2007-08

8 Note that this survey has not yet been released, but is expected to be released in early April.

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

Market Conditions

The global financial crisis had, and continues to have, a significant impact on global financial markets and international financial institutions. Internationally, banks continue to struggle – a total of 146 banks failed in America in the 12 months to February 2010. [10] The latest profit results for the major international banks, while having returned to positive territory, remain low relative to outcomes enjoyed prior to the downturn.

While the crisis has also had a substantial impact on the domestic economy, the Australian economy was the only advanced economy to record positive growth in 2009.[11] A combination of accommodative monetary policy, flexible labour markets and fiscal stimulus helped to cushion Australia from the worst of the global downturn.

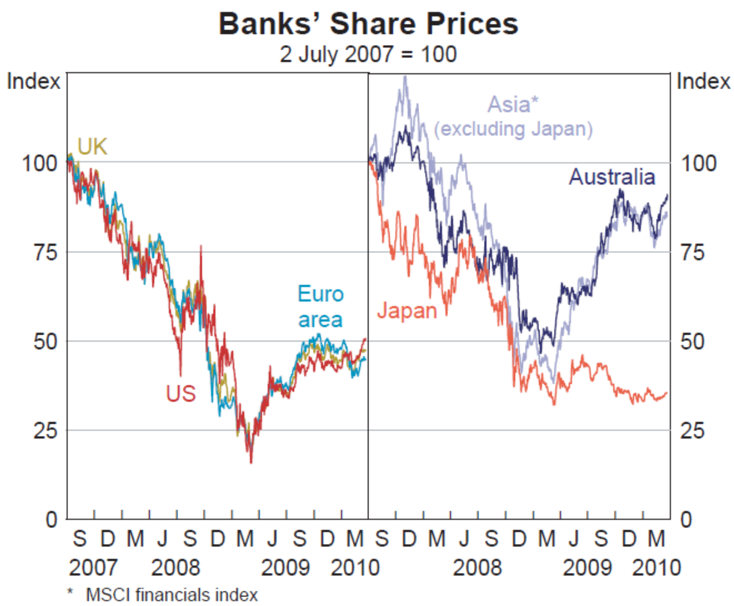
Against this backdrop, it is not all that surprising to find that the Australian banks have performed more strongly than international banks over this period. The RBA has noted that:

"The Australian financial system has, throughout the crisis period, remained resilient. In aggregate, the Australian banks have experienced only a modest decline in profitability. While there has been some diversity of performance across banks, increases in loan losses and impairments across the banking system to date have been lower than in many other countries. The banks are well capitalised and have strengthened their balance sheets further with significant new equity raisings during the past year."[12]

And that:

"Income streams for banks have remained comparatively stable, losses from securities and loans have been relatively mild and, as a whole, the banking system has continued to be very profitable."[13]

As illustrated in the chart below,[14] Australian banks have seen a far stronger recovery in their share prices than in other major developed economies.



While the profitability of the banking sector as a whole has held up to some extent, what has become apparent in the Australian market is that the global financial crisis has allowed the major banks to improve their market share

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[10] Reserve Bank of Australia, *Financial Stability Review*, March 2010, p. 4.

[11] The Hon Wayne Swan, *IMF World Economic Outlook Update, January 2010 (media release)*, 27 January 2010

[12] Reserve Bank of Australia, *Financial Stability Report*, September 2009, p. 1.

[13] Reserve Bank of Australia, *Financial Stability Review*, March 2010, p. 17.

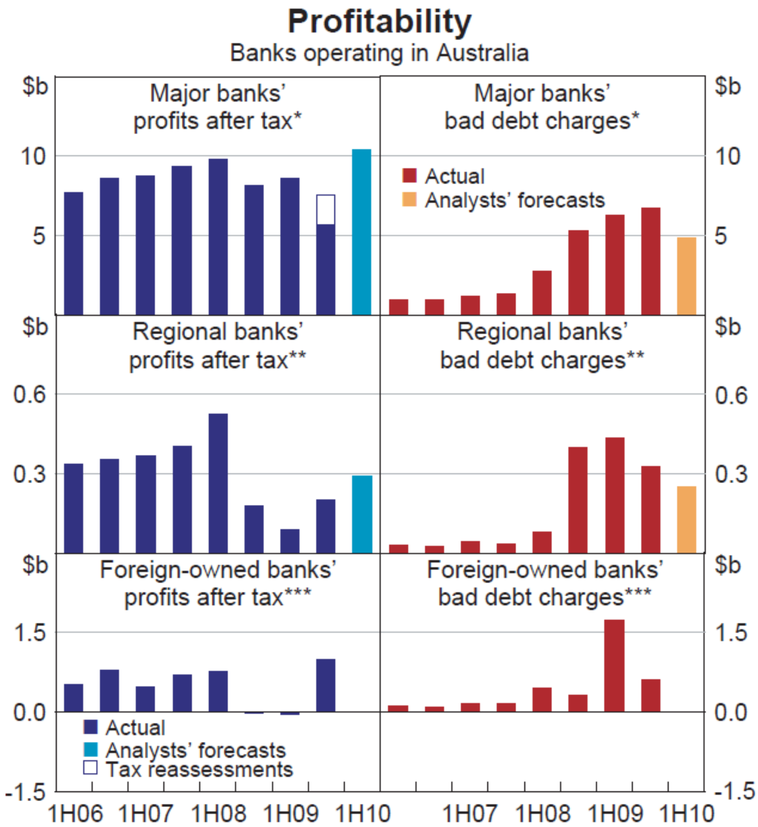
[14] Ibid., p. 3.

and profitability at the expense of smaller banks and financial institutions. Prior to the global financial crisis, the major banks generated approximately 60 per cent of all new owner-occupier loan approvals. By the end of 2009, their share of the new mortgage market had increased to around 80 per cent.[15]

Net interest income is another area where there has been a marked difference between the performance of the major banks and the regional banks. Net interest income from domestic operations grew by more than 20 per cent for the major banks over the past 12 months. Over the same period, net interest income for regional banks fell. The RBA noted that the increase in interest income for the major banks was a reflection of both increasing market share and increased margins between borrowing and lending rates.[16]

Given these differences, it is not surprising that the major banks have been more profitable than their competitors during the downturn. There are clear differences between the performance of major banks, regional banks and foreign owned banks. While the profit margin for all banks was 18.4 per cent for the 12 months to 30 September 2009, the major banks achieved a margin of 21.6 per cent while other domestic banks operated at 8.6 per cent.[17]

As illustrated in the chart below,[18] the downturn in profits was shallower for the major banks than the regional and foreign owned banks. In addition, profitability for the major banks is expected to exceed 2008 highs in the first half of 2010, while for regional banks profits in the first half of 2010 are only expected to be half as high as the 2008 peak.



* Second half figures are half year to December for CBA and half year to September for ANZ, NAB and Westpac. Includes St George, and Bankwest from the first half of 2009.
** Second half figures are half year to December for Suncorp-Metway and Bendigo and Adelaide Bank, and half year to August for Bank of Queensland.
*** Second half figures are half year to September. Includes Bankwest up to the second half of 2008.

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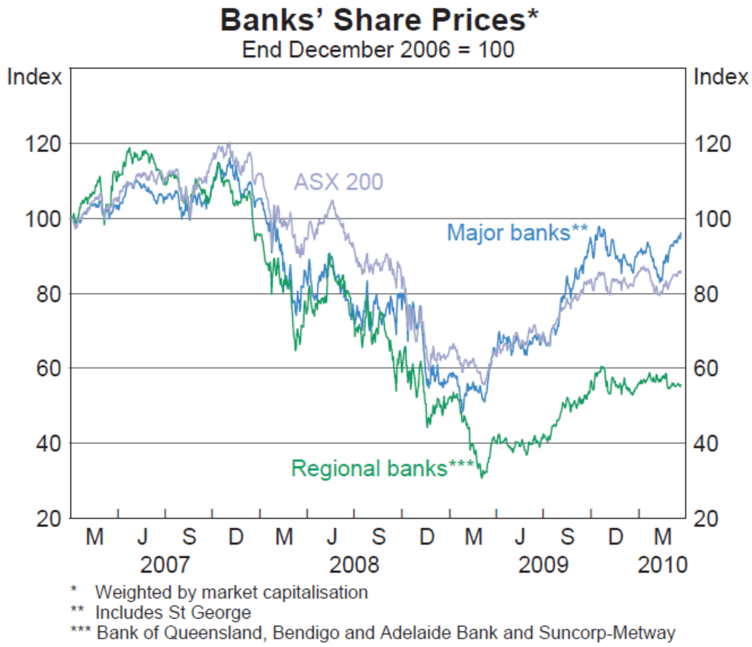
15 Reserve Bank of Australia, *Financial Stability Review,* March 2010, p. 30.

16 Ibid., p. 18.

17 APRA, *Quarterly Bank Performance Statistics,* September 2009.

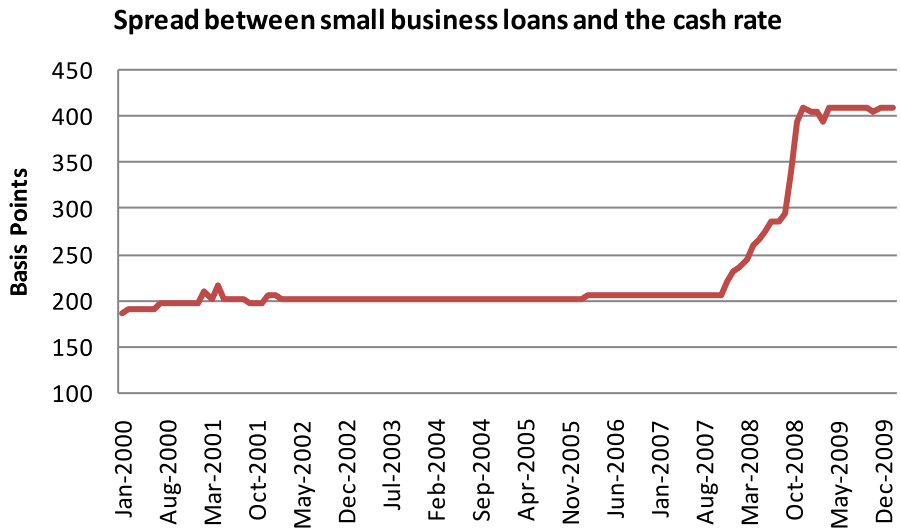
18 Reserve Bank of Australia, *Financial Stability Review,* March 2010, p.18.

Share prices for the major domestic banks have significantly outperformed regional banks since the beginning of 2007. Despite the dramatic impact of the global financial crisis on banking and financial institutions in other countries, the major banks have also outperformed the ASX 200 over this period.



Trends in small business finance

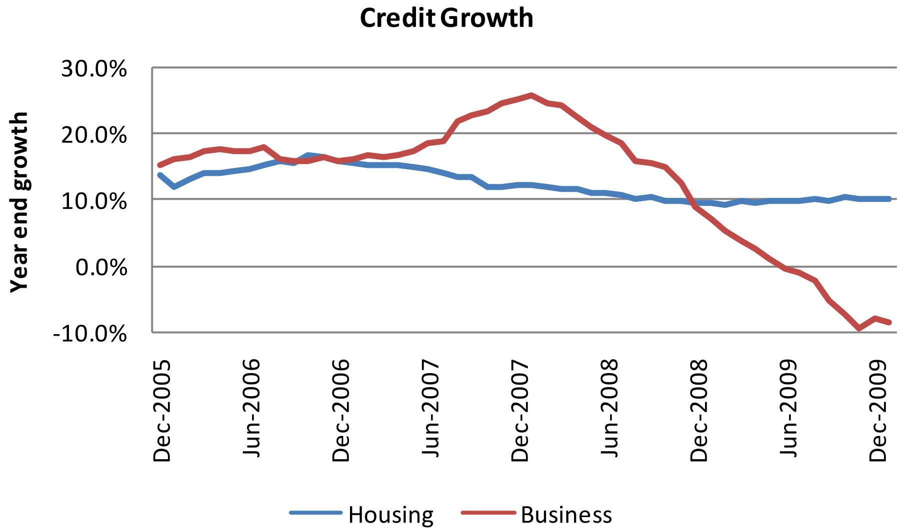
Since the start of the decade, spreads between the cash rate and small business indicator rates have fluctuated between about 180 and 210 basis points. However, the sub-prime fallout in late 2007 and the subsequent onset of the global financial crisis in late 2008 saw these spreads blow out to over 400 basis points.[19] Despite indications that the worst is behind us, spreads on small business loans remain at historic highs.



[19] Reserve Bank of Australia, *Statistical Tables – Indicator Lending Rates*

Growth in business credit has also declined sharply since the end of 2007. Following an extended period of sustained growth, business credit has now fallen for 12 successive months. It is impossible to say with certainty whether the decrease in business credit has been primarily due to businesses deleveraging and seeking alternative sources of finance, or excessive risk aversion on the part of banks curtailing business access to finance. However, it is likely that access to finance and cost of funds has been at least partially responsible for the decline.

It is interesting to note that the reduction in business credit has been far more dramatic than the reduction in housing credit, which has remained fairly stable over the same period, and has not fallen below an annual growth rate of 9 per cent.[20]



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

Examples of tightening lending criteria include:

- **Increasing demands on interest only loans.** A small business restaurant owner held an interest only loan with a major bank. The small business had developed a business plan which allowed for positive cash flow once the interest payments had been taken into consideration. Despite remaining cash flow positive, the bank reassessed the loan and required that principal repayments also be made. As the small business was unable to make these additional payments, they fell outside terms with the bank and onto penalty rates. As a result, the small business owner sold the restaurant. In this instance, a profitable and sustainable small business was closed due to a tightening of the bank's lending criteria.
- **Increasing documentary and security requirements.** A small business developer with an approved and partially drawn-down loan found the bank repeatedly increased the requirements for documentary evidence to be provided. The small business was also required to provide increased levels of security. Meeting the additional requests from the bank was time consuming and onerous, and the back-and-forth caused so much delay in making draw-downs on the loan that eventually the small business owner found it easier to use their own cash to meet financing needs.
- **Reluctance to consider applications on their individual merits.** A small business wanted to increase the size of a mortgage on a warehouse. The building had a permanent tenant on a multiple year contract, and the rental payments being made by the tenant were more than sufficient to cover the mortgage repayments. In addition, the size of the mortgage would still be less than 60 per cent of the value of the

[20] Reserve Bank of Australia, *Statistical Tables – Lending and Credit Aggregates*

property. Banks were unwilling to consider the particular circumstances of the application and the quality of the business, and instead turned down the application using a basic "one size fits all" approach. As a result, the business was forced to borrow from an alternative lending institution, where the interest and fees were much higher than current market rates. This extra cost has placed an additional burden on the business bottom line.

In addition, the NSW Business Chamber has been informed of the following example by the Illawarra Chapter of the Property Council:

- **Tightening requirements for sales off the plan.** A small business involved in property development has found it more difficult to secure property development financing. Prior to the global financial crisis, the business was typically able to secure bank finance once roughly 20 per cent of floorspace had been sold off the plan. Financial institutions have since tightened their lending criteria so far that the small business now requires up to 80 per cent of the floorspace to be pre-sold before finance is approved. This change has been a significant impediment for the business, and has constrained construction work.

Submissions presented to the Committee by other organisations have also identified a range of other examples of banks restricting access to finance for profitable and sustainable small business operations.

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

The RBA is aware of the tightening in lending criteria, and has noted that:

"On the supply side, banks have also tightened the terms and conditions under which they are willing to extend credit to businesses and households. This contrasts with the easing in standards seen in earlier years, and reflects the banking sector's response to a perceived increase in the probability of default among most categories of borrowers. As these risks have risen, banks have sought to conserve capital by directing their lending towards less risky ventures. Over the past couple of years, banks have generally also raised risk margins and strengthened non-price loan conditions, such as collateral requirements and loan covenants."[21]

BASEL Committee recommendations developed over the course of 2009 also have the capacity to further constrain small business access to finance. While appreciating the need to protect to the world economy from a repeat of the global financial crisis, it is important to acknowledge that the existing regulation of Australian banks was effective in insulating them from the worst of the global fallout.

The reduction in competition in the banking sector has been partly responsible for the increase in interest margins and has made it easier for the banks to shift greater amounts of risk off their balance sheets through stricter lending requirements, such as higher levels of collateral. The reduction in competitive pressures is of considerable concern, and has been noted by the Chair of the ACCC, who has referred to Australian banking as a "comfortable oligopoly."

While interest rate spreads on small business loans have blown out dramatically since the global financial crisis, spreads on mortgages have remained more stable over this period, and there have been signs among the banks of greater competition in this area. For example, the Credit Union of Australia recently cut their variable interest rate on home mortgages by 25 basis points.[22]

Traditionally, the focus on competition in the banking sector has been directed towards the treatment of mortgage holding Australian householders. There are indications that the greater public focus on the home mortgage sector has meant that business borrowers are effectively cross-subsidising home mortgage borrowers. This issue was recently acknowledged in a public speech by Reserve Bank Assistant Governor Guy Debelle. [23]

The Assistant Governor stated that, "Looking forward, the competitive state of the current [mortgage] market is reflected in the fact that home lending rates have not risen by as much as funding costs." In relation to business loans, it was noted that "In contrast, banks' business and personal loans have increased by even more relative to the cash rate and by more than the rise in funding costs." This point is illustrated in the chart below.

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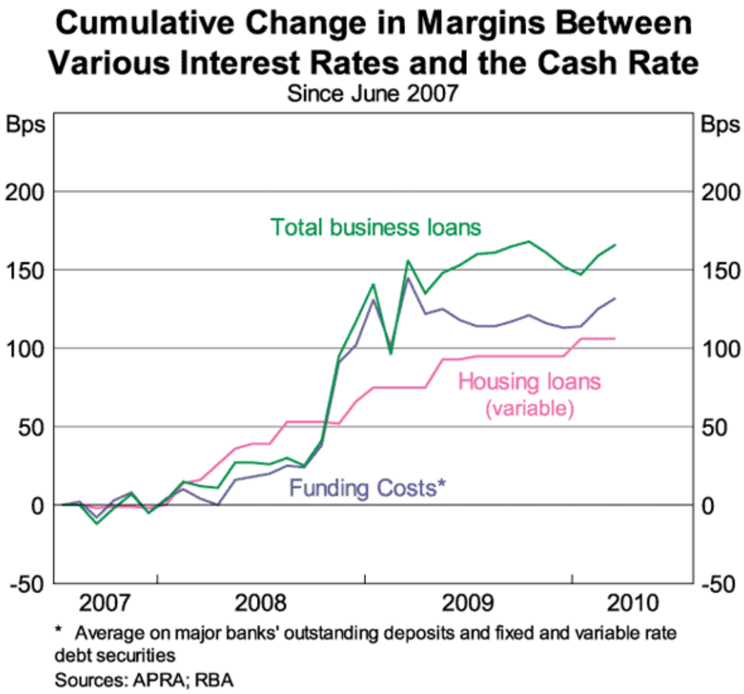
[21] Reserve Bank of Australia, *Financial Stability Review,* September 2009, p.29.

[22] Sydney Morning Herald, *Nothing magic about big four's two-trick show,* 28 March 2010.

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



Improving competition

In this environment, the NSW Business Chamber makes the following recommendations to both facilitate increased competition and ensure that existing levels of competition are not further eroded.

Recommendation 1: The Government should continue to remain open to new market entrants, both domestic and foreign, as a means of reinvigorating competition within this sector.

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

Recommendation 2: Further mergers within the banking sector should be considered very carefully, and the impact of such mergers on competition in the market must be acknowledged.

The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. Mergers reduce competitive pressures in the banking sector. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further mergers should be carefully considered and their impact on competition acknowledged.

Recommendation 3: Consideration should also be given to new measures to increase competition in small business lending.

In 2008, the Government acknowledged that greater competition was needed in the household mortgage sector, and implemented a range of measures to address this issue by reducing barriers to switching providers (see Box 1 below). The introduction of similar measures targeting small business lenders may be appropriate. In particular, an open Productivity Commission review of the costs and constraints faced by small businesses in attracting finance could give this issue greater prominence, and assist in promoting competitive pressures within this part of the banking sector.

Box 1 - Promoting competition in mortgage lending

In February 2008, the Government announced a package of measures aimed at making it easier for customers to switch banks if they were not satisfied with their current provider. The Account Switching Package announced by the Government was designed to "reduce unnecessary barriers to customers changing providers and increase consumer awareness of financial services products and their costs, and how to go about switching if that is what suits them best."[24] These measures became fully operational from the beginning of November 2008.[25]

As part of the package, ASIC undertook an industry review of entry, exit and early termination fees, which was completed in April 2008.[26] While the scope of the review was limited to home mortgage accounts, the review did find that there was a great deal of variety in the type and magnitude of fees charged across the various mortgage products. Interestingly, between the launch of the bank switching package in February 2008 and the release of the ASIC review in April, one of the four major banks introduced a new mortgage product free of exit fees.

The Government's actions recognised the inertia and difficulty mortgage holders face in changing banks. A survey in late 2009 found that of those unlikely to switch provider in the next twelve months, only half were staying with their bank or financial institution because they were satisfied with its service. The other half stayed with their current provider for a variety of other reasons, such as it being too difficult, requiring too much effort, or the belief that all providers are equally bad.[27]

It is unclear how much switching has increased as a result of the Government's Account Switching Package. However, it does appear that the greater prominence given to the sector by ASIC's review of fees and charges placed downward pressure on product pricing and increased competitive pressures within the sector.

Recommendation 4: The Government should put greater pressure on banks to keep small business lending rates down, and publicise good and poor performance in this area by individual banks.

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

Business organisation can also play a role in raising public awareness about the performance of banks in relation to small business borrowers.

24 The Hon Wayne Swan, *Rudd Government Making it Easier for Australian Families to Switch Banks – Media Release*, 9 February 2008.

25 The Hon Wayne Swan, *Bank Switching Measures Fully Operational – Media Release*, 31 October 2008.

26 The Hon Wayne Swan, *ASIC Review of Mortgage Entry and Exit Fees – Media Release*, 5 April 2008.

27 CHOICE, *Bank Satisfaction Survey*, 30 September 2009.

The role of Government guarantees

While the Australian economy weathered the global financial crisis in better shape than most other advanced economies, we were not immune from its impacts. Following the collapse of Lehman Brothers in September 2008, pressures on the cost and availability of funding increased dramatically in all countries, including Australia. Guarantees have formed an important part of the Government's response, which have shown themselves to be effective tools to assist in supporting financial flows.

In October 2008, the Government announced that it would guarantee bank deposits and bank's wholesale funding to assist in alleviating pressures on financial markets.[28] The RBA has acknowledged the positive effect that these measures had on stability in the Australian financial system:

"These measures were successful in assuaging investor unease, and funding conditions have improved steadily over the course of 2009 as risk aversion has abated. Banks have issued a large volume of long-term debt in domestic and offshore markets, increasingly without the backing of the Government's guarantee, and deposit growth remains firm."[29]

In March 2009, the Government announced that it would also guarantee State and Territory Government borrowing. This initiative recognised that "pulling back on critical nation-building infrastructure investment now would mean ever slower growth and higher unemployment into the future." [30]

Collectively, the three guarantees implemented by the Federal Government in response to the global financial crisis covered over $220 billion in loans and deposits as at 18 September 2009.[31] In implementing these guarantees, the Government has demonstrated a willingness to shift risks from the market onto its own balance sheet where necessary to allow the economy to operate in an efficient manner.

The guarantees can also be expected to have positive implications for the Government's fiscal position. In relation to the wholesale funding and deposit guarantees, the Government noted in the 200-09 MYEFO that "the amount of revenue collected from the guarantee fee cannot be quantified at this time. Revenue collections will depend on the level of uptake by institutions."[32] The 2009-10 Budget made the same point in relation to the guarantee of state and territory borrowing. [33]

However, taking the current levels of exposure identified in September 2009, coupled with the pricing structures outlined by the Government, it can be estimated that annual revenue to the Government from the implementation of these guarantees is likely to be over a billion dollars per annum. This represents a significant boost to Government revenues, and is particularly useful to the Government at a time in the economic cycle when it has been necessary to run temporary deficits.

The key point is that the implementation of an appropriately priced government guarantee is an effective way of rejuvenating the flow of finance to productive parts of the economy without requiring additional Government expenditure. Indeed, it is likely that the wholesale funding and State and Territory borrowing guarantees will be revenue positive for the Government.

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[28] The Hon Kevin Rudd, *Global Financial Crisis – Media Release,* 12 October 2008.

[29] Reserve Bank of Australia, *Financial Stability Review,* September 2009, p.26.

[30] The Hon Wayne Swan, *Temporary Guarantee of State Borrowing – Media Release,* 25 March 2009.

[31] Commonwealth Treasury, *2009-10 MYEFO – Appendix C: Statement of Risks,* November 2009.

[32] Commonwealth Treasury, *2008-09 MYEFO,* November 2008, p. 122.

[33] Commonwealth Treasury, *2009-10 Budget – Budget Paper No. 2,* May 2009, p. 18.

A guarantee of small business loans

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

- In the **United Kingdom,** the Enterprise Finance Guarantee, managed by the Department for Business Innovation and Skills, provides a loan guarantee scheme to facilitate business lending to SMEs.[34]
- Under **Canada's** small business financing program, the Canadian government guarantees 85 per cent of eligible small business loans. The guarantee is provided to the small business in exchange for a fee, and in this way, the scheme is self financing.[35]
- In the **United States,** the Small Business Administration (SBA) guarantees loans made to small businesses by financial institutions.[36]

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

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

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

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

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

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

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

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

The guarantee should not cover 100 per cent of the loan. This idea follows on from the principle that banks should be responsible for the financial assessment. In order to avoid moral hazard issues, it is important that banks

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

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

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

still have a financial incentive to carefully consider loan applications. Not guaranteeing the loan in its entirety provides the banks with this incentive.

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

The guarantee should not be capped, and should be available to the entire small business sector. While the scheme would only be eligible to individual loans below a certain threshold, for the scheme to be effective and to avoid rationing of finance, it is important that the total amount the Government is willing to guarantee is uncapped. It is currently estimated that small business loans total around $200 billion. Assuming around a quarter of small businesses take up the guarantee, the total Government exposure would be $50 billion, which is relatively small when compared to the wholesale funding and State borrowing guarantees.

Consistent with the wholesale funding and State funding guarantees, the amount of fee revenue the Government would collect and the value of loans guaranteed cannot be accurately assessed until after the scheme is in place.

Recommendation 5: Consideration should be given to the implementation of a guarantee of small business loans in Australia, taking into consideration the principles outlined above.

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

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