SUBMISSION BY THE

Housing Industry Association

to the

Senate Standing Committee on Economics Inquiry

Into

Access of Small Business to Finance

26 March 2010

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HIA is the leading industry association in the Australian residential building sector, supporting the businesses and interests of over 43,000 builders, contractors, manufacturers, suppliers, building professionals and business partners.

HIA members include businesses of all sizes, ranging from individuals working as independent contractors and home based small businesses, to large publicly listed companies. 85% of all new home building work in Australia is performed by HIA members, predominantly small businesses.

1 Executive Summary

There remains an acute shortage of finance available to smaller residential developers. A survey of HIA members found that 75 per cent of small business members surveyed now faces greater difficulty obtaining finance than was the case before the advent of the Global Financial Crisis (GFC). HIA is therefore strongly supportive of the Senate Standing Committee on Economics Inquiry into Access of Small Business to Finance.

The lack of access to finance for residential development is restraining the supply of new housing across Australia.

In the second half of 2009 Australia emerged from the longest down cycle in new home building in its post war history. The first stage of a recovery is underway due to highly stimulatory monetary and fiscal policies in 2009. However, this policy stimulus will begin to wane from mid 2010 and a lack of access to finance is a principle obstacle to a sustained new home building recovery emerging from 2010/11.

The crux of the problem is that 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. The end result is substantial demand from credit worthy home buyers for a constrained level of housing supply. With housing stock growing significantly slower than population-induced demand, inevitably there is unnecessary upward pressure on existing home values and therefore, ultimately, on the extent of future interest rate rises.

With regard to specific aspects of the lack of access to finance for the residential sector, there are nine key, related issues:-

- The level of pre-sales required by Australia’s banks for detached house and low density developments is substantially higher than normal and is unachievable within the industry structure of the residential construction sector.

- Banks are lending a reduced share of the finished value of a project, which means many projects are unviable due to a prohibitive cost of equity.

- This prohibitive cost of equity is generating an unlevel playing field and therefore eroding competition in an industry that is normally one of the most competitive industries in Australia.

- The reduction in the share of a finished value of a project that banks are willing to finance is lowering the rate of return for potential residential investors and diverting investment to sources other than new residential dwellings.

- Banks are asking for a larger proportion of a loan or for the entire loan advanced for a project to be paid back prior to all stages of the project being completed. This leaves developers requiring more capital to advance to the next stage of a development even although the original loan was for the entire project.

- Bank valuations of residential projects are too conservative and are preventing viable projects from proceeding.
- There are reports of conditional approvals being given for residential land development, but the land valuation subsequently being revised downwards.
- There are reports of bank guidelines on approved residential developments being changed without notification after the project has already commenced.
- The length of time it takes for banks to process and make progress payments for residential developments has increased substantially, generating unnecessary uncertainty, creating cash flow difficulties, and an un-budgeted interest rate bill for final new home buyers.

Without urgent rectification of these substantial finance-related obstacles to boosting housing supply, the risk of a premature end to the current new home building recovery is considerably increased. Given the sizeable employment generated by the residential construction sector, and the large multiplier impact of the sector on employment and output elsewhere in the economy, a premature downturn in residential construction would have a major detrimental impact on the growth prospects for the Australian economy.

HIA recommends that policies be developed to encourage greater lending to smaller residential developers. The four major banks should be encouraged to adopt more flexible lending practices to credit worthy smaller residential developers and the entry of more banks and non-bank lenders needs to occur. One of the greatest obstacles to financing is a lack of competition.

2 The finance environment for small residential sector businesses

2.1.1 Background

The residential development sector comprises a large number of small and medium sized companies, in addition to a much lower proportion of large companies. There is currently a lack of available finance for smaller residential developers due primarily to two factors – a high level of pre-sale requirement and a lower share of the finished value of a project being financed by Australian banks.

These two primary factors, together with a number of related factors, are significantly reducing competition in what was naturally a very competitive and highly efficient industry. The final result is fewer new homes being built than would otherwise be occurring, despite considerable demand for new homes from households that banks deem to be credit worthy customers.

This final result of less new home building is being manifested in upward pressure on existing home values and on median weekly rents of a magnitude that would not otherwise be apparent. Less new home building is therefore eroding housing affordability in both the owner occupier and rental sectors.

2.1.2 Pre-sale requirements

The pre-sale requirements of the banks for residential projects consisting of detached houses and/or low density semi-detached housing product have increased considerably.

An HIA survey of small residential developers (the full results for which appear in the Appendix from page 12) found that 76 per cent of respondents are now expected to achieve a minimum of 41 per cent pre-sales. Prior to the tightening of pre-sales requirements, 76 per cent of respondents reported having a pre-sales requirement of no more than 40 per cent. 48 per cent of respondents reported now facing pre-sales requirements in excess of 60 per cent compared to a previous situation where over half of respondents faced a pre-sales requirement of a maximum of 20 per cent.

These substantially higher pre-sales requirements are for unconditional contracts and exclude the additional requirement from banks now for a 10 per cent deposit. Under normal circumstances less than 10 per cent of buyers would pay a 5 per cent deposit (typically a legislated limit in state laws) on a new residential development lot and less than 5 per cent of buyers would pay a 10 per cent deposit.

HIA's survey results also confirm the fact that in many instances banks are demanding proof of the authenticity of pre-sales. 49 per cent of respondents reported being asked to provide client details as proof of pre-sales and a majority of respondents (63 per cent) reported that this requirement from the banks had only emerged in the last six months.

The onerous nature of the current pre-sales environment is inconsistent with the structure of the detached and low density residential construction sector in Australia.

New home buyers in Australia have a clear preference for seeing the residential development site before signing a contract to have a detached or low density non-detached home built. This sector of the industry therefore does not have the same structure as the medium/high density apartment sector where a significant number of purchases can often occur 'off the plan'.

The crux of the problem with high pre-sales requirements for detached/low density housing is therefore that small residential developers often cannot provide a sufficient number of pre-sales to obtain finance to develop a site simply because such pre-sales cannot be made without the client first being able to see the site to be developed.

Given that 85 per cent of all new home starts each year in Australia occur in the detached/low density sector, clearly the current pre-sale framework is acting as a considerable constraint on new home building and an impossible challenge for smaller residential developers. The reduction in the involvement of smaller residential developers is also reducing competition which will ultimately drive up prices.

2.1.3 Lower funding of final project value

The normal situation for detached/low density residential development is that banks were willing to lend in excess of 70 per cent of the finished value of a project.

HIA's survey found that 71 per cent of respondents were now being lent a lower share of the finished value of a project than prior to the GFC. Only 23 per cent of respondents reported that their bank was lending in excess of 70 per cent of the finished value of a project, compared to 92 per cent of respondents reporting their bank lending in excess of 70 per cent prior to the GFC. In the current environment, 67 per cent of respondents reported only being lent between 51 per cent and 70 per cent of a finished project.

The result of this situation is that smaller residential developers need substantial equity in a project, in many instances augmented by mezzanine debt funding, for that project to proceed. This requirement is beyond the financial capability of a majority of these developers.

With small residential developers now required to find a considerably higher share of equity or equity/mezzanine debt than previously, and in many instances that is simply not possible, the cost of equity renders many projects unviable.

Consequently, while there has normally been a level playing field for residential development this is currently not the case as a large number of businesses are shut out of consideration for projects. Therefore competition in the residential development sector has been considerably eroded.

2.1.4 Additional Constraints

There are a significant number of additional constraints on residential development, four of which are outlined below.

Firstly, a significant additional constraint on residential development is the blow-out in progress payment periods.

It is standard procedure for banks to make progress payments on residential projects. The progress payments were generally made within seven working days.

The HIA survey found that 53 per cent of respondents had experienced an increase in the number of days it took to receive progress payments and the situation had deteriorated over the last three to six months in particular. 72 per cent of these respondents had experienced an increase of at least eleven days in the time it took to receive progress payments.

These delays ultimately add to the interest bill of new home buyers who had no cause to anticipate a deviation from the normal seven day turnaround for progress payments to be made to developers of residential projects.

Secondly, there are reports of banks changing the guidelines and payment requirements of small residential developer's part way through an operational project. These reports include long standing clients of specific banks and developers who concentrate on lower end, affordable housing projects.

Thirdly, banks are asking for loans to be paid back at the completion of a particular stage of a residential project rather than at the end of an entire project, even although the loan was extended for the entire project.

Fourthly, banks continue to exert considerable pressure for conservative valuations to be made of residential projects. The viability of projects ultimately depends on the valuation, and with many valuations generally below market, perfectly viable projects are not proceeding. There are also reports of projects receiving conditional finance approval based on a particular valuation only to receive a lower valuation three months later.

3 The Residential Construction Industry

The residential construction industry is a vital component of the Australian economy in terms of employment, output, and as a key leading indicator of overall economic growth.

3.1.1 The Construction Industry and Small Business

There are over 400,000 businesses operating in the construction industry that are either non-employing businesses (sole traders) or small businesses[1]. Sole traders and small businesses make up over 99 per cent of the businesses operating in the entire industry.

3.1.2 The Residential Construction Industry's Linkages with the Australian Economy

In 2008/09, Australia's Housing and Renovation Industries directly contributed approximately $64 billion to Australia's Economy. While this strong result accounted for 5.3 per cent of Australia's Gross Domestic Product (GDP), when combined with those primary and secondary businesses that indirectly supply to the construction industry, the overall effect is far stronger in terms of both employment and output.

[1] See: ABS catalogue 8155.0

Over and above the direct contribution to the economy, construction industry activity has 'flow-on' impacts on the activities of other industries. The possible size of these impacts can be illustrated using the ABS multiplier for construction[2] based on inter-industry flows. The total multiplier for output and employment in the construction industry is estimated by the ABS to be 2.866. So, for every $1 million increase in construction output, there is an increase in output elsewhere in the economy of $2.9 million. In output terms, an extra $1 million of construction expenditure also involves $217,000 of employee earnings and $241,000 of corporate and small business profits.

In terms of employment, an extra $1 million of construction expenditure generates 9 construction jobs. More generally, as activity increases in the construction industry, as well as in the suppliers to that industry and the ‘suppliers to the suppliers’, there is an increase in wages and salaries to employees throughout this chain.

Very recent evidence reinforces the fact that new home building correlates strongly with economic growth in Australia. A premature end to the current up-cycle in new home building would not only signal a deterioration in Australia’s acute housing shortage, but would also be sending a signal of an impending slowdown in economic growth.

HIA estimates that over the next 10 years alone, taking account of current population projections, Australia will need to build 1.92 million dwellings, well ahead of the 1.5 million dwellings completed over the last 10 years. It is therefore vital that the current new home building recovery is sustained.

Failure to adequately address a national housing shortage will carry both social and economic consequences. From an economic perspective, the capacity of the economy to grow at a comparable rate with the population growth will be hindered. Productivity gains will be stifled by an inadequate allocation of labour. In many cases, people will be unable to dwell a suitable distance from the employment opportunities.

The housing shortage means that property prices will remain out of reach for many first home buyers. Those locked out of the property market face very low rental vacancy rates, skyrocketing rents, and often unsuitable housing options in terms of size and proximity to employment opportunities.

Overall, failure to address the nation’s critical housing shortage will constrict the capacity of the economy to grow sustainably and will reduce the nation’s living standards.

[2] See: http://www.abs.gov.au/AUSSTATS/ABS@.NSF/94713ad445ff1425ca25682000192af2/ed6220072793785eca256b360003228f!OpenDocument

4 Competition in Small Business Lending

There is a lack of competition in the small business lending market with the four major banks dominating the market at the expense of smaller banks and non-bank lenders.

HIA's survey found that 52 per cent of respondents were of the view that there has been a reduction in competition in the small business lending market over the last 12 months to two years.

Of the 52 per cent of respondents who considered there to have been a reduction in competition, 55 per cent stated that they thought the level of competition had declined significantly while a further 27 per cent stated the level of decline had been substantial.

88 per cent of respondents stated that the Federal Government's banking guarantees had not helped the ability of their business to acquire finance.

The combination of increased market share of major banks, the aiding of this development through amalgamation, and the effective withdrawal of Suncorp has led to a number of negative factors for small residential developers.

- High line fees are being added to loans approved, often rendering projects unviable despite clear demand for the project.
- The complexity of major bank requirements prior to approving or rejecting loans has increased.
- Major banks are taking a considerably longer period of time to approve or decline a project than 18 months ago.
- Major banks are charging higher interest rates on small business loans.

This final point highlights a considerable disadvantage that exists for small businesses even before the negative impact of credit rationing is considered.

During the GFC major banks subsidised their mortgage loan books by charging higher interest rates on small business loans. Between September 2008 and April 2009 the Reserve Bank of Australia lowered the Official Cash Rate (OCR) by 425 basis points. The discounted variable mortgage rate was lowered by 385 basis points over the same period. However, the largest decline for small business loan rates was 300 basis points on residential secured term loans and overdrafts. The reduction on unsecured term loans and overdrafts and small overdrafts was only around 280 basis points.

Consequently the cost of borrowing base for small business was already higher before the tightening interest rate cycle began and in spite of credit rationing and a lack of competition in the small business lending sector.

5 Conclusions and Recommendations

There is a basic requirement for the encouragement of greater lending to the small residential development sector in order to ensure that adequate new housing supply is available to meet a substantial pent-up demand for new homes.

HIA is of the view that the Federal Government has a role to play in encouraging the major banks to engage in a higher level of lending to credit worthy small residential developers and within a speedier timeframe.

This approach is justified and necessary given there is a disconnection in the residential sector being generated by the current lending practices of the major banks. Major banks are willingly extending finance to credit worthy households in order to provide these households with the ability to satisfy their demand for new or existing homes. At the same time, however, major banks are rationing finance to credit worthy small residential developers, therefore preventing the adequate provision of housing supply required to meet the demand being funded by these same banks.

Clearly this situation is both inequitable and untenable. Furthermore, this situation is aggravating a pre-existing large housing shortage in Australia and subsequently creating an unnecessary degree of upward pressure on existing home values and weekly rents, which will ultimately manifest itself in higher interest rates.

HIA is of the view that the Federal Government has a role to play in encouraging a greater level of competition in the banking sector through the entry of a larger number of banks and also the increased involvement of non-bank lenders.

The difficulties that small residential developers are experiencing in accessing finance cannot be justified within the context of the overall change in the global banking sector brought about by the GFC. The higher cost of intermediation will have a dampening impact on business lending globally. However, there is no justification for this situation having a material impact here in Australia, especially in the residential construction sector where major banks continue to lend freely to one side of the market, namely households, while rationing lending (at higher interest rates) to the providers of the homes those households are demanding.

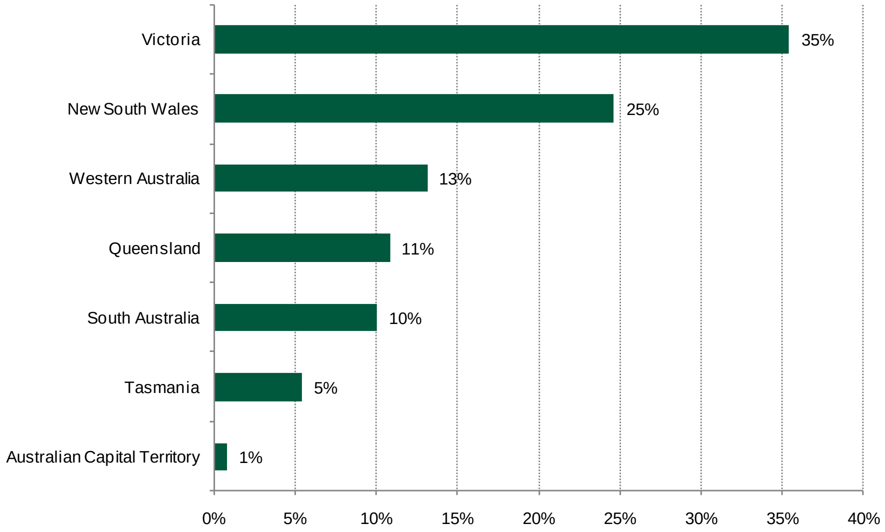
6 APPENDIX

A survey of HIA members provided 130 responses from small businesses who engaged in residential development activity.

- The majority of respondents were from Victoria, 35 per cent, followed by New South Wales, 25 per cent.

Where in Australia do you primarily develop and/or build?

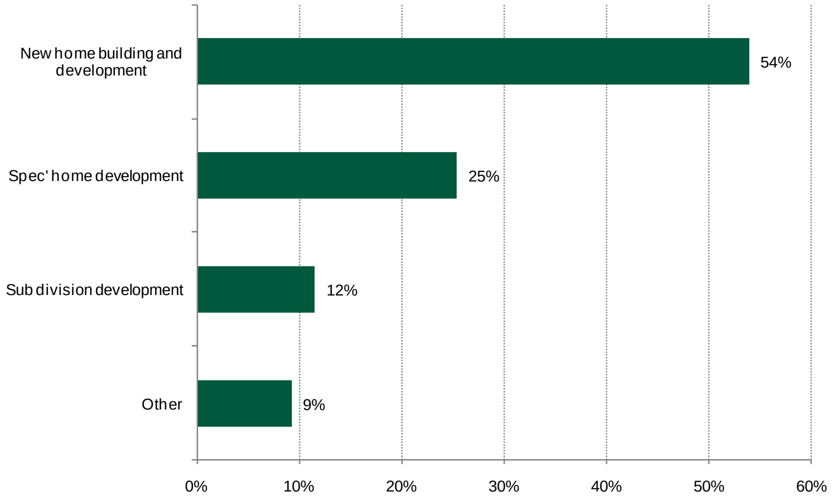
Source: HIA Economics Group



- 54 per cent of respondents stated they were primarily engaged in New home building and development. 25 per cent stated ‘Spec’ home development, 12 per cent Sub division development, and 9 per cent ‘Other’.

What activity do you primarily engage in?

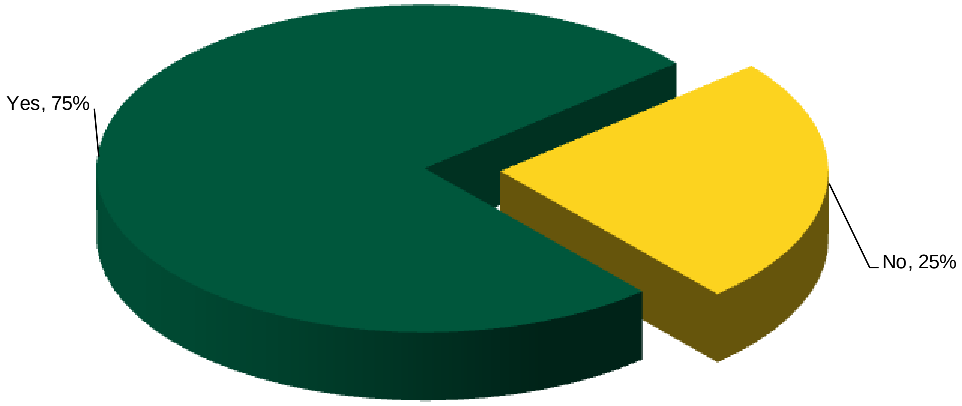
Source: HIA Economics Group



- The majority of respondents, 75 per cent, stated that they were having greater difficulty obtaining finance now than they were before the Global Financial Crisis (GFC).

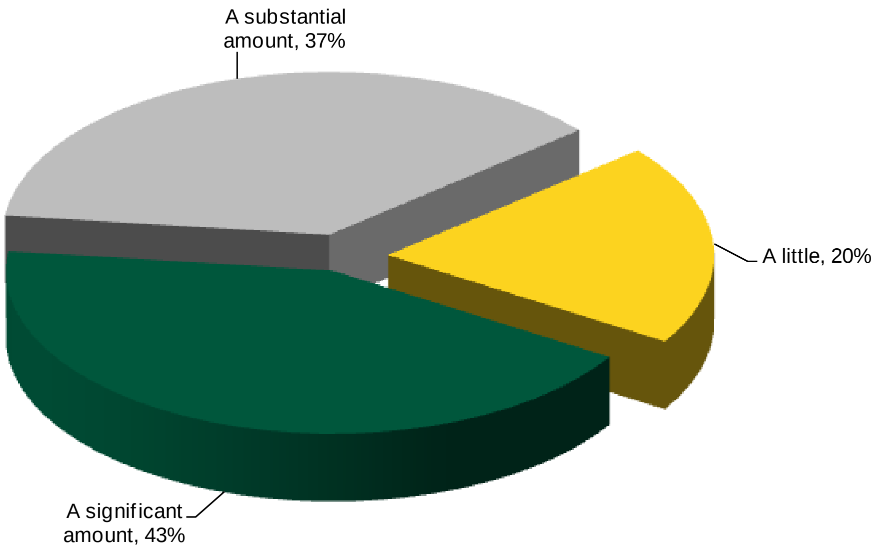
Do you have greater difficulty obtaining finance now than you did before the Global Financial Crisis (GFC)?

Source: HIA Economics Group



- 43 per cent of respondents stated it was now significantly more difficult to obtain finance. 37 per cent stated it was now substantially more difficult to obtain finance.

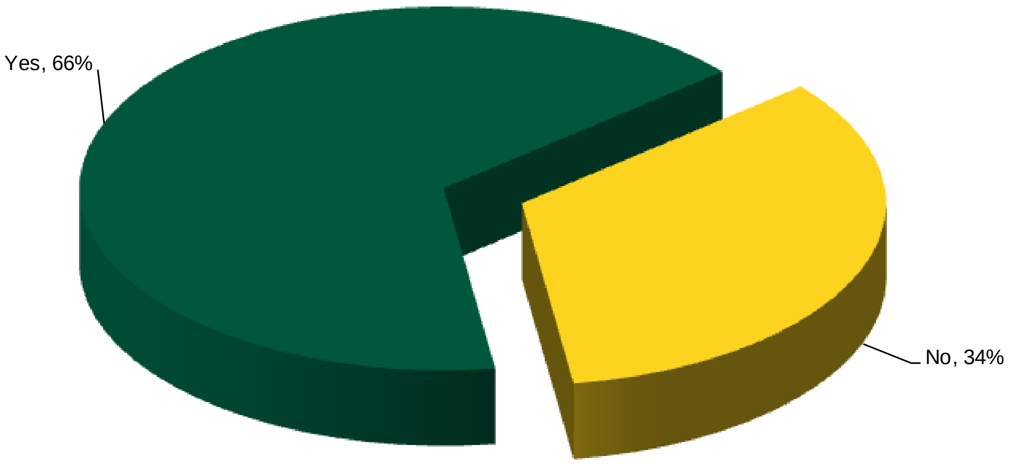
How much more difficult is it?



- The majority of respondents, 66 per cent, stated that pre-sale requirements are higher now than pre-GFC.

Do you find that pre-sale requirements are higher now than pre-GFC?

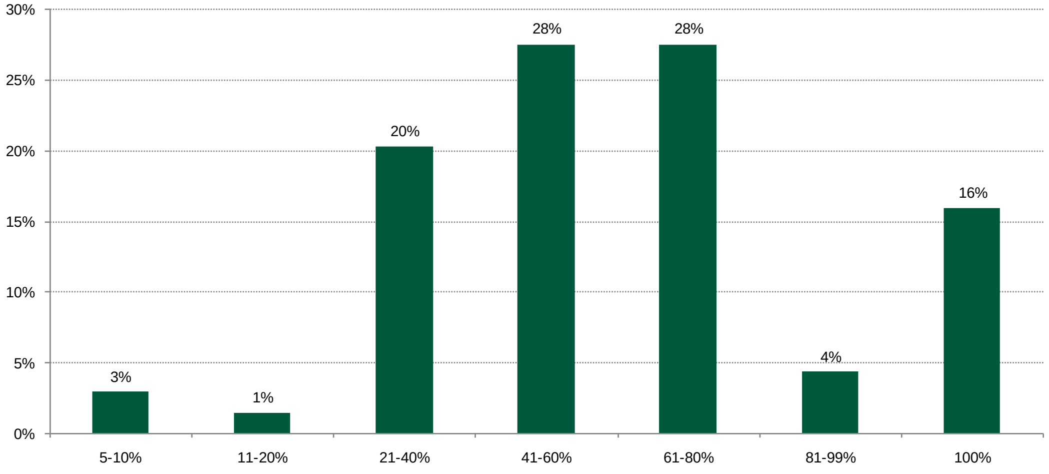
Source: HIA Economics Group



- 28 per cent each of respondents stated that the pre-sale percentage required now was between 41-60% or between 61-80%. 20 per cent stated it was between 21-40%, 16 per cent stated 100%. 4 per cent stated between 81-99%, 3 per cent stated between 5-10% and 1 per cent stated between 11-20%.

What pre-sale % is required now?

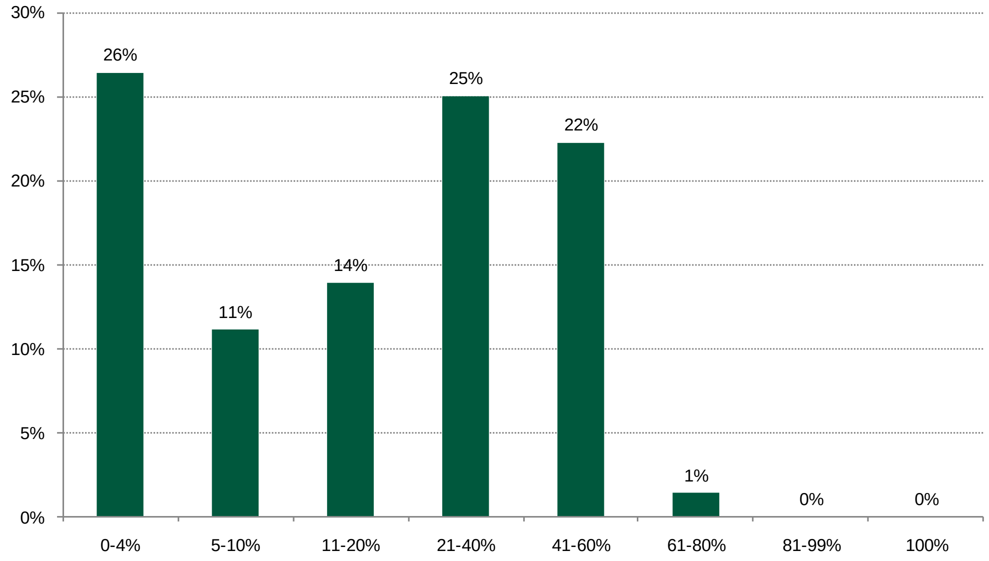
Source: HIA Economics Group



- 26 per cent of respondents stated that before the GFC the pre-sale percentage required was between 0-4%. 25 per cent stated between 21-40%, 22 per cent stated between 41-60%, 14 per cent stated between 11-20% and 11 per cent stated between 5-10%. 1 per cent of respondents stated it was between 61-80% before the GFC.

What pre-sale % used to be required?

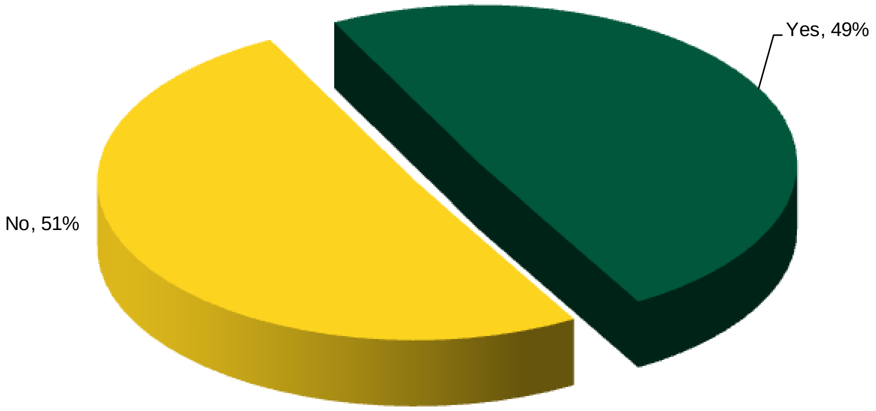
Source: HIA Economics Group



- 51 per cent of respondents stated that they were not required by their bank to provide client details in order to prove the authenticity of their pre-sales and 49 per cent stated they were required to prove the client details.

Have you been required by your bank to provide client details in order to 'prove' the authenticity of your pre-sales?

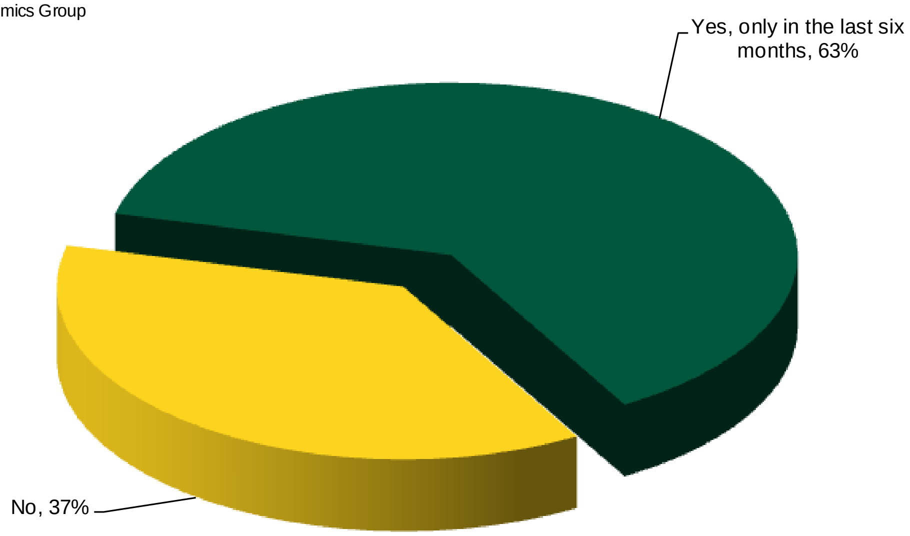
Source: HIA Economics Group



- Of the 49 per cent of respondents who stated they were required by their bank to provide client details to prove the authenticity of their pre-sales, 63 per cent stated that this has only started happening in the last 6 months.

Has this only happened in the last six months or has it been longer than that?

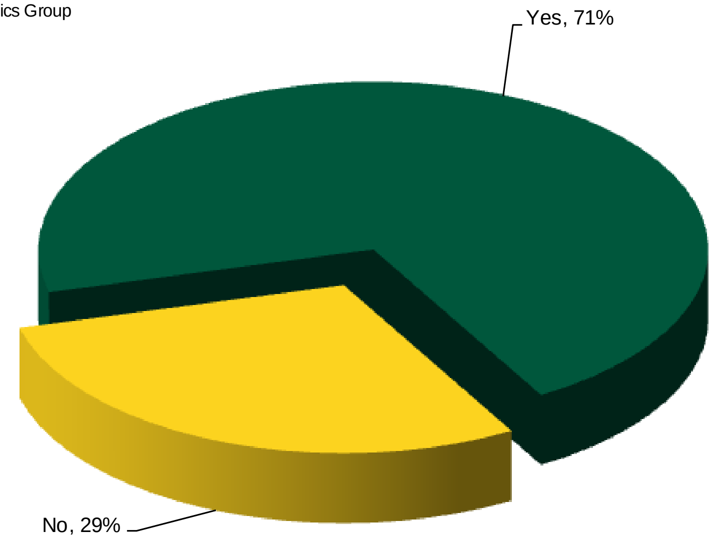
Source: HIA Economics Group



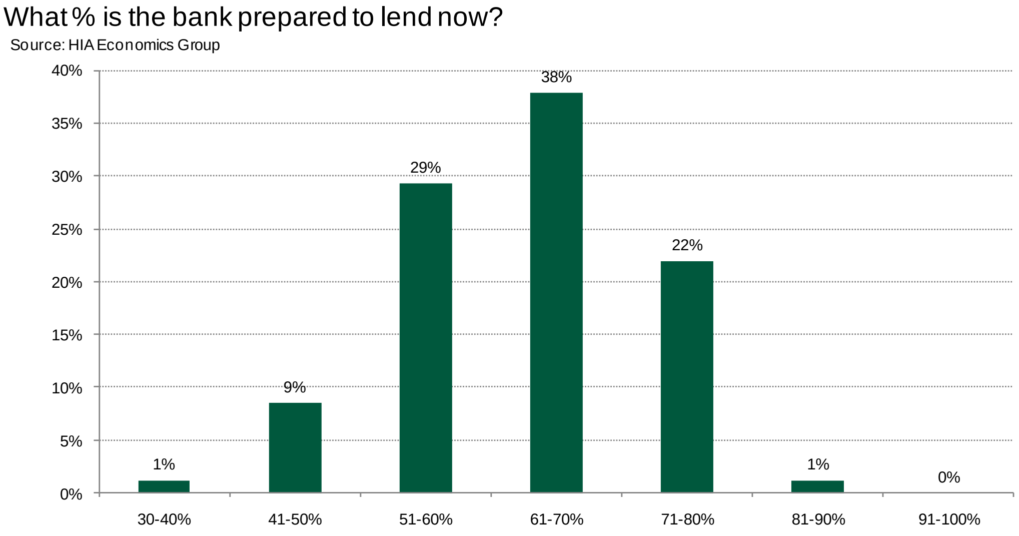
- 71 per cent of respondents stated that their bank lends less of the finished value of a project now than pre-GCF.

Does your bank lend less of the finished value of a project now than pre-GFC?

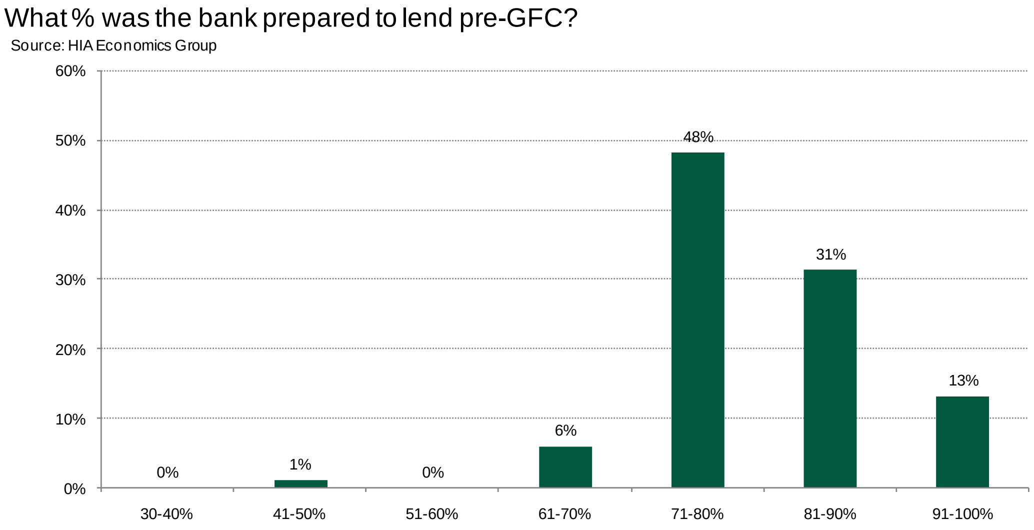
Source: HIA Economics Group



- Of the 71 per cent of respondents who stated their bank lends less of the finished value of a project now than pre-GCF, 38 per cent stated their bank would now lend between 61-70% of the finished value of a project. 29 per cent stated between 51-60%, 22 per cent stated between 71-80% and 9 per cent stated between 41-50%. 1 per cent each stated between 30-40% and 81-90%.



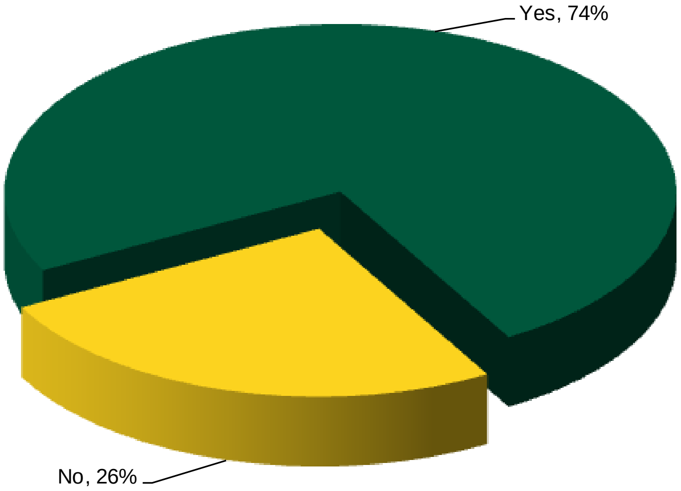
- 48 per cent of respondents stated that the percentage their bank was prepared to lend pre-GFC was between 71-81%. 31 per cent state between 81-90%, 13 per cent stated between 91-100%, 6 per cent stated between 61-70% and 1 per cent stated between 41-50%.



- The majority, 74 per cent, of respondents stated that the general difficulty in obtaining finance and a requirement for increased equity share in projects is turning investors off residential development because the return does not appeal.

Is the general difficulty in obtaining finance and a requirement for increased equity share in projects turning investors off residential development because the return does not appeal?

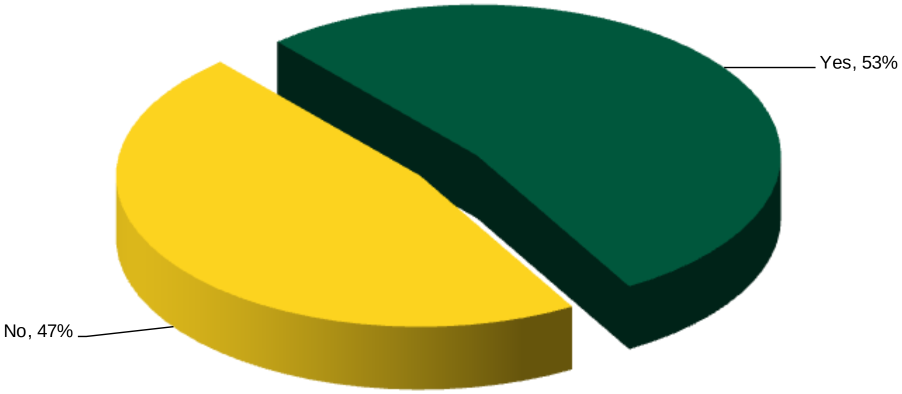
Source: HIA Economics Group



- 53 per cent of respondents stated it is taking longer to get progress payments from banks now than it was pre-GFC.

Is it taking longer to get progress payments for projects from banks now than it was pre-GFC?

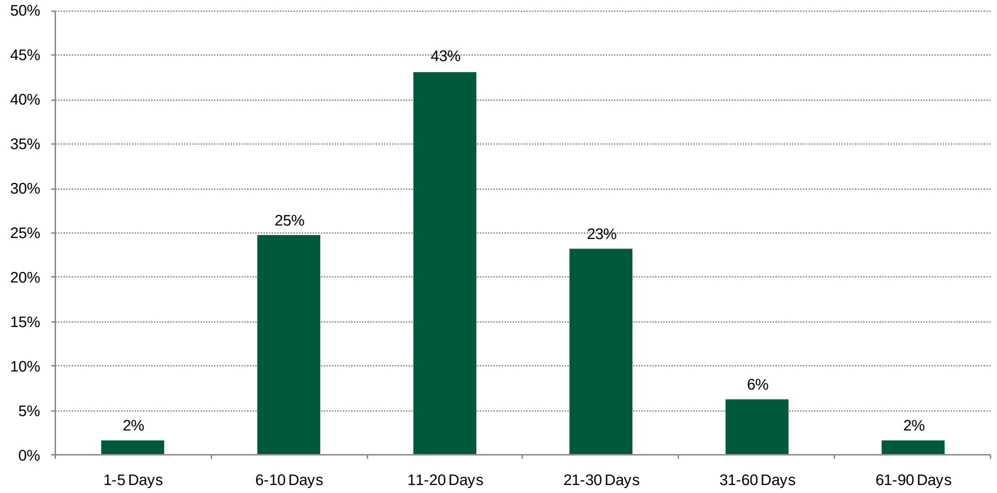
Source: HIA Economics Group



- Of the 53 per cent of respondents who stated it is taking longer to get progress payments from banks now than it was pre-GFC, 43 per cent stated it was taking between 11-20 days longer. 25 per cent stated between 6-10 days, 23 per cent stated between 21-30 days, 6 per cent stated between 31-60 days and 2 per cent each stated between 1-5 days and 61-90 days.

How much longer?

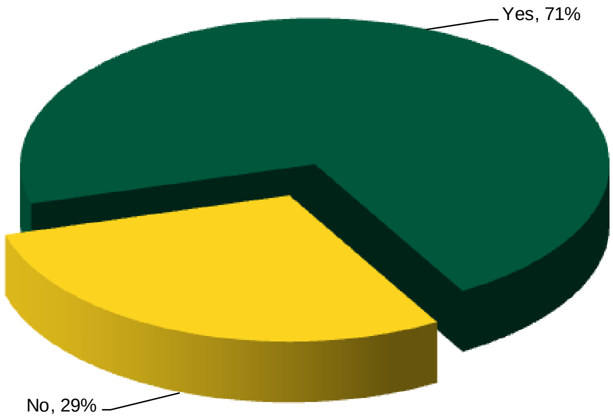
Source: HIA Economics Group



- Of the 53 per cent of respondents who stated it is taking longer to get progress payments from banks now than it was pre-GFC, 71 per cent stated this delay in progress payments has become even worse still over the last three to six months.

Has this delay in progress payments got even worse still over the last three to six months?

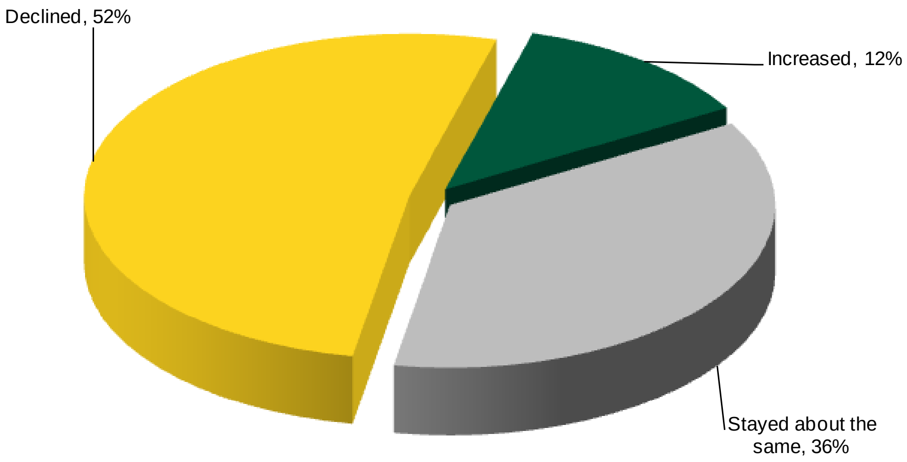
Source: HIA Economics Group



- 52 per cent of respondents stated that in their view over the last 12 months to 2 years competition in small business lending markets has declined.

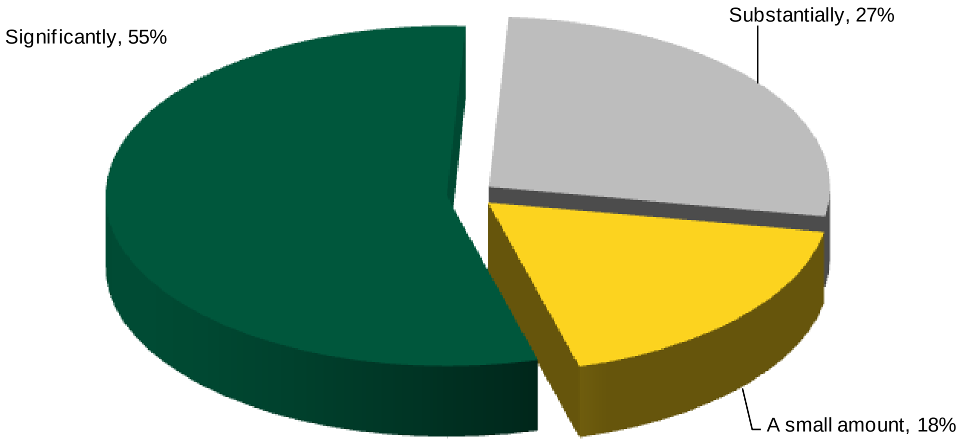
In your view, over the last 12 months to 2 years has competition in the small business lending market

Source: HIA Economics Group



- Of the 52 per cent of respondents who stated that there had been a decline in competition in the small business lending market over the last 12 months to 2 years, 55 per cent stated that competition had declined significantly, 27 per cent stated a substantial decline, and 18 per cent stated that competition had declined a small amount.

By how much has competition for small business lending declined?



- 88 per cent of respondents stated that the Federal Government’s banking guarantees has not helped the ability of their business to acquire finance.

Has the Federal government's banking guarantees helped the ability of your business to acquire finance?

Source: HIA Economics Group