Submission to Senate Economics Legislation Committee

Prospa

6 March 2019 (redacted 12 March)

Committee Secretary
Senate Economics Legislation Committee
Department of the Senate
PO Box 6100
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CANBERRA ACT 2600
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Executive Summary

Prospa is pleased to present this submission to the Senate Economics Committee for consideration in relation to the **Australian Business Securitisation Fund Bill 2019** (the Bill). We understand the Bill has been referred to obtain further information about how the fund actually works and determine stakeholder views.

[redacted]

Our submission is informed by our more than seven years of small business lending experience delivering more than $920m of unsecured finance to small business and sourcing the funding to support that lending activity.

Small businesses are considered the engine room of the economy in Australia due to their influence — they represent 97% of all businesses, 44% of private sector employment and 35% of GDP[1]. Many small businesses find it challenging to access finance, especially without providing real estate as security. In addition, small businesses perceive access to finance as becoming increasingly difficult.

We are very supportive of the proposed Bill and strongly believe implementation of the Australian Business Securitisation Fund (the 'Fund') will substantially enhance the availability of affordable finance for small business owners in Australia. This will help small businesses to better manage cash flow and invest in growth and will have a significant positive impact on economic growth and job creation.

We believe Prospa is uniquely placed to respond, given our in depth knowledge and experience of the Australian market, and our funding journey: including operation of a warehouse securitisation vehicle for unsecured small business loans since August 2015, and being the only operator in the region to have an independently rated securitisation vehicle to fund unsecured small business loans.

Prospa believes the relative advantage enjoyed by larger banks in using their market power and economies of scale to maintain their market share, which is limiting the flow of capital to small businesses, should be balanced to some extent by Government intervention.

The Fund will create a more diverse and competitive finance market; and bring forward capital market acceptance of the small business unsecured loan asset class by 2-3 years. This would be achieved by significantly increasing volumes of loans delivered, and significantly expediting the track record that the debt capital market participants are seeking as a prerequisite to their participation as fixed income investors.

The Fund will therefore increase the availability of competitively priced funding for small business and at the same time support the development of competition to the traditional banking sector.

Additional benefits include:

- With increasing data sets, accelerate the progressive removal of the Rating Cap which in turn would facilitate the ability of participants to attract capital at a cost that aligns with more established products such as credit cards and unsecured personal loans
- Increased awareness and consideration from Government involvement would result in a material step up of supply of private debt capital for platforms catering to the capital needs of small businesses and would in turn reduce the cost of that capital
- Increased awareness and a responsible increase in supply will directly benefit small businesses seeking affordable capital
- Demonstrate Government commitment to small business, innovation and doing things differently
- Deliver data to measure the economic impact of access to affordable finance for small business and on the wider economy.

[1] Parliament of Australia, Department of Parliamentary Services, Research Paper Series, 2017-18.

The Fund would be operated and run by AOFM who we believe have the requisite skill and experience. Access to the Fund should be tightly controlled granted to small business lenders that meet set criteria and have a strong track record in lending to small business in Australia.

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

Private sector lenders like Prospa can become significant economic enablers. We have recently undertaken independent research with RFi Group and The CIE to quantify the economic impact of Prospa lending on small business. The results show that every $1m of Prospa lending results in $4m boost to GDP and 57 FTE positions maintained, showing our lending is a significant economic enabler.

[redacted]

Based on recent international experience in the UK, support of alternative lenders such as Prospa through access to a Fund could enable us to significantly increase our lending over the five years by increasing awareness and consideration to switch from a traditional lender.

This paper documents the rationale for the Fund and how we believe it will solve the problem of access to affordable finance for small businesses. We have also outlined our funding journey and included insights based on our experience and our comments on how the fund will work.

Given our funding journey and in depth knowledge and experience of the Australian market, plus the fact we already have a warehouse securitisation vehicle for unsecured small business loans, we hope these insights are valuable.

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About Prospa

Since 2012, we have delivered over $920m to more than 18,000 small businesses, making us the leading online small business lender in Australia. We have more than 60,000 data-sets in our data warehouse and have nearly 7 years of experience in assessing and monitoring credit performance in the small business sector across Australia.

We help small businesses access 'unsecured[2]' finance to seize opportunities and manage their cash flow. With finance, business owners can seize opportunities for growth, manage their cash flow and ultimately create jobs and contribute to economic development. Without access to finance small businesses can fail to grow, or worse – fail to exist.

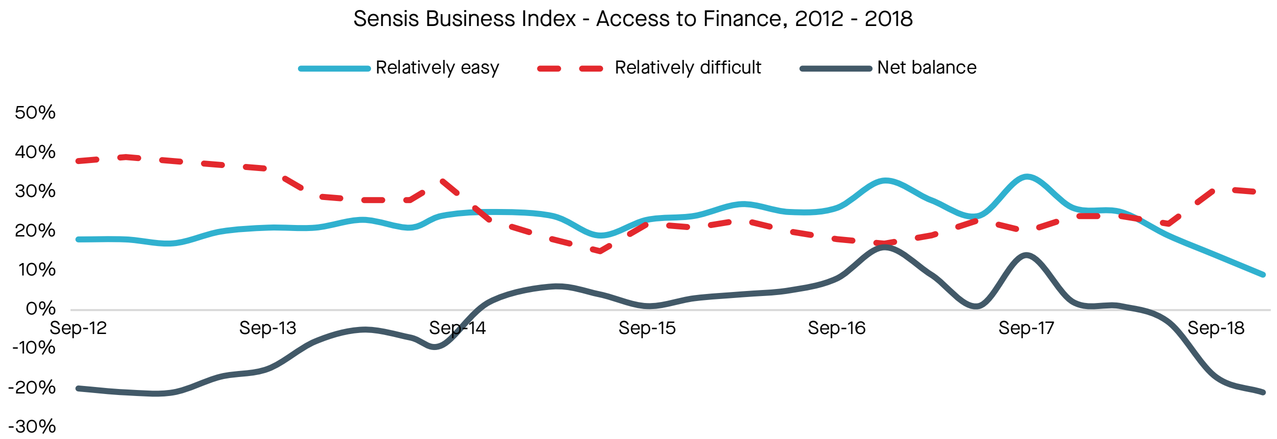
Prospa is Australian-owned and operated and our proprietary technology platform was built specifically to suit the needs of Australian small business. Using our smart technology platform and an online application, we can approve and fund loans of between $5,000 and $250,000 in less than one business day. We focus on the health of a business to determine creditworthiness and use over 450 data points in our credit assessments. Prospa loans are often made in circumstances where traditional bank lending would only require a longer lead time and/or asset backing to support the loan (e.g. the family home may be required as security).

The comments noted in this document are based on our experience and the challenges we have faced in raising capital efficiently, and the flow on impact when deploying that capital to small businesses.

Lack of lending to small businesses

Small businesses are considered the engine room of the economy in Australia due to their influence — they represent 97% of all businesses, 44% of private sector employment and 35% of GDP[3]. Many small businesses find it challenging to access finance, especially without providing real estate as security. In addition, small businesses perceive access to finance as becoming increasingly difficult.

According to the December 2018 Sensis Business Index 30% of small businesses that tried to access finance in the previous quarter were unsuccessful. As shown in Figure 1 below, in the December 2018 quarter, businesses stating it was relatively easy to access finance decreased 5 points to 9%, while the net balance increased to -21%.



Market failure in small business lending

[2] In the context of this paper, 'unsecured' is used to describe our small business loan product where no asset security is required to access funds up to $100k.

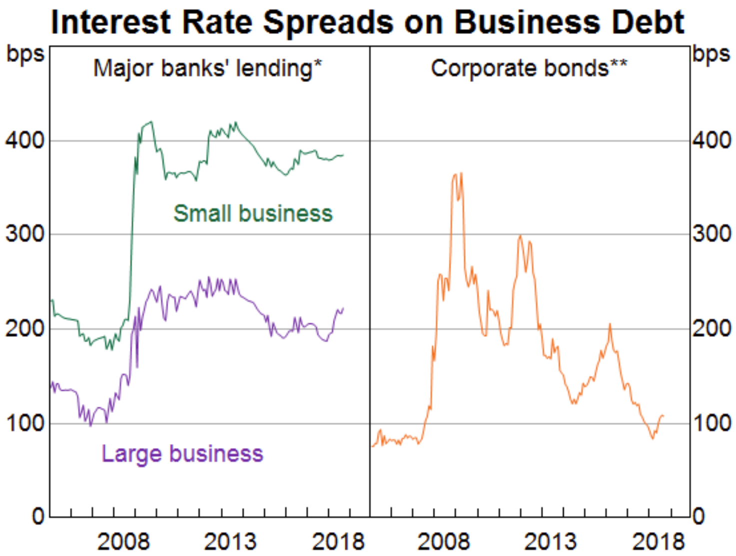
[3] Parliament of Australia, Department of Parliamentary Services, Research Paper Series, 2017-18.

[redacted] [redacted]

Over recent years, there has been strong competition for large business lending, which has resulted in a decline in the interest rate spread on large business loans.

Large businesses also have access to a wider range of funding sources, including secured bank loans, corporate bond markets and syndicated lending. In contrast, competition has been less vigorous for small business lending and the interest rates on small business loans have remained relatively high.

In the case of business lending, the traditional lenders will generally make funds available to larger companies which possess significant assets and balance sheets, but this is largely to the exclusion of smaller business. This is reported by APRA in their submission to the Productivity Commission dated September 2017[4].



* Rates on outstanding lending; spread to cash rate; small business loans are defined as those below $2 million

** Five-year secondary market non-resource corporate bond spreads over AGS

Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australian Branch

Proven demand by small business

There is un-met demand for finance for small business. The most under-served sector is for unsecured business loans of less than $100,000 targeted at the 2.3 million Australian small businesses under 20 employees[5]. Prospa has delivered more than $920m in unsecured small business loans in five years, with an average loan size of just $29,000. Our customers range across all industry sectors and geographies and tend to be on the smaller side. This is because larger small businesses are likely to be more profitable for banks due to higher credit balances and transaction volumes, and the banks put more effort into keeping them. These customers will also tend to require a wider range of products so are likely to be more entrenched in their bank relationship.

Prospa customers are likely to have lower bank account credit balances and transactional volumes, and are unlikely to have asset security against which to access lower cost finance.

[4] APRA submission to Productivity Commission, September 2017 http://www.apra.gov.au/Submissions/Documents/APRA-PC-Submission-FINAL-September2017.pdf

[5] ABS 8165 June 2018 (released February 2019)

Inertia to adopt alternative lenders

Research by the RFi Group for the SME Banking Council in December 2018 shows that while awareness of alternative finance options is growing (51% in June 2017 up from 34% in September 2015) the number of small businesses who would consider using an alternative finance provider has remained steady over the past two years with a small bump at the tail end of 2018 (15% in December 2018 compared to 11% in September 2015).[6]

This is despite the high customer satisfaction ratings and net promoter scores (NPS) experienced by alternative finance providers. As an example, Prospa has a score of 9.8/10 on independent review site TrustPilot and has a positive NPS of 77, while the average NPS for NAB over 2018 fell to negative 16, and Commbank reported their NPS for business banking customers was negative 19.6 in June 2018[7]..

This inertia also remains despite there being very little innovation in small business banking in terms of product innovation or customer experience by the banks, who have focused their innovation efforts on more profitable segments of their business, especially personal banking, wealth products and mortgages.

One of the key barriers to switching is a desire by small businesses to have all financial information in one place. For this reason, the implementation of a mandated open banking regime by the Government will significantly improve the ability of new banks to compete with incumbents.

The main reason small business owners cite for using an alternative lender was a fast approval time (16%), simple online application process (13%), no need for asset security (11%), no need to provide extensive documentation (9%), flexible repayment options (9%) and fast funding (9%). Of those that would not consider use of an alternative lender, the desire for a one-stop-shop (i.e. they can consolidate all products and services with their current bank) was the most commonly cited barrier.[8]

Lack of effective competition

The concentration of market share with the traditional lenders, and the lack of any substantive change in market share – despite five years of activity by alternative lenders – suggests small businesses are not responding to improvements in the speed and ease of service, and there is no effective competition in the business banking sector. An overall consequence of this is that the large established banks are currently maintaining high stable market shares.

High costs for alternative lenders

Because there is weak customer response by small businesses in relation to small business lending, and strong product linkages and information advantages to incumbents, alternative lenders have to invest heavily in order to attract customers away from the incumbent banks. These marketing costs are over and above the inherent costs of entry and expansion.

It also takes some time in market before alternative lenders are able to acquire a sufficient volume of customers to recover the costs of entry and expansion and/or to have a sufficient presence in the market commensurate with any initial investment.

The high cost of customer acquisition is a barrier to entry and expansion in small business banking and small business lending. It is also a contributing factor to higher operating costs for alternative lenders.

Access to low cost debt funding is constrained

[6] Australian SME Banking Council, December 2018 survey - RFi Research
[7] Commbank Annual Review 2018
[8] Australian SME Banking Council, December 2018 survey - RFi Research

Unsecured small business lending is inherently of higher risk, and will therefore attract a higher cost of capital. Access to funds to set up and as debt funding will take these risks and the competition barriers listed above into account, and funding will come at a higher cost than can be accessed by existing banks and non-ADI lenders that include consumer credit and mortgage and asset-back small business credit products.

In the case of traditional approaches to banking this has required large capital reserves from conservative institutions focused on limited risk, and therefore market segments that are reliable. Risk has been limited by the ability to call on collateral or the underlying asset of the loan or alternatively the secured asset base of the borrower which is large enough to cover the borrowed amount in the event of foreclosure. This has resulted in a financial system which provides sufficient and available capital for the mortgage market.

[redacted]

Prospa's funding journey

Our biggest challenge as a business has not been finding customers, but finding cost-effective funding so we can keep up with escalating market demand. Raising capital has been difficult, time-consuming and expensive. Lack of supply and a rating cap have added to constraints and increased our cost of funding.

We're further advanced than most fintechs, but we're still very constrained and constantly seeking innovative ways to reduce our funding costs. Any reductions in funding that we achieve we seek to pass on to our customers, and we've been able to shift our rates downwards three times in the last two years.

When Prospa was founded in 2012, and even now, unsecured small business loans were a relatively new asset class especially compared with mortgages, equipment finance, auto leases and personal loans.

The key hurdle to attracting debt capital for any asset class is being able to demonstrate credible loan performance track record over a sustained period of time, ideally 5-10 years, and across a relatively large portfolio. This would typically include:

- Performance of loans originated each month over the full term of the loan – in Prospa's case an average of 13 months
- A statistically significant portfolio of loans that are a representative sample of the market and provide a degree of confidence about the credit approval process; and
- Performance through negative economic cycles including, for example, periods of slow growth and/or recession.

In the absence of such data, it is challenging to attract a wider group of debt capital market participants, which results in reliance on funders who seek a higher compensation for their willingness to accept a perceived higher risk.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Turning a 'catch 22' into a virtuous circle

The inter-dependence between attracting a lower cost of funds and the availability of funding to grow the portfolio creates a 'catch 22', and results in a materially longer gestation period to reach all parts of the small business market.

It has taken significant time, effort and investment across our business to build infrastructure that can meet the standards required by debt capital market participants (funders and rating agency). Debt capital market participants focus on the performance of the portfolio and ensuring originators such as Prospa have a strong financial position – i.e. are financially viable and profitable.

There is a dearth of debt capital market participants at the [redacted] rating and this creates an inefficient market (low demand and higher pricing) for the Rated ABS issued to fund unsecured small business loans. The Fund will provide the lower cost funding needed to generate the volume.

Reducing the cost of funds through access to the Fund, and progressively passing this on to customers, creates a strong tailwind for the sector as it assists with increasing volume, particularly for those customers where the underlying purpose for the funds can be price sensitive ie turns the 'catch 22' into a virtuous circle.

[redacted]

Without the Fund, market participants will be forced to continue to pass on the higher cost of funding to small business customers.

Despite these capital market limitations, we continue to focus on optimising our cost of funds and pass on savings to our customers, with a view to eventually making our offering attractive across the total small business finance market opportunity, which we believe is in excess of $20 billion per annum.

The economic impact of Prospa lending

Private sector lenders like Prospa can become significant economic enablers.

In 2019, we engaged RFi Group and the Centre for International Economics (CIE) to investigate the economic impact of our lending to small businesses in Australia. For this exercise, we undertook a detailed economic impact assessment on how the funds we lent over the period 2013 – 2018 benefited our customers through increases in revenue and employment and the flow-on effects of these funds to the wider economy. The results of the research indicated:

- Our lending has contributed $3.65 billion to Australian GDP and resulted in more than 52,500 annual FTE positions being maintained over the period 2013 – 2018;
- In 2018 alone, our lending added $1.697 billion to Australian GDP and resulted in close to 24,400 FTE positions being maintained;
- 82% of customers believe their most recent loan from us resulted in an increase in business revenue;
- For every $1 million in our lending there is a corresponding $4 million increase in GDP and 57 annual FTE positions are maintained; and
- The industry sectors where our lending made the biggest impact on employment in 2018 were construction, hospitality, other services and retail.

The impact of the Fund

Prospa believes the strong advantage enjoyed by larger banks, in using their market power and economies of scale to maintain their market share, should be balanced to some extent by Government intervention. Fintech is a proven and efficient distribution model for making finance available to small businesses, meaning the Government does not need to place itself in the position of being the lender.

The Fund would increase the availability of competitively priced and therefore affordable funding for small business, and at the same time support the development of competition to the traditional banking sector, especially given the context of the Royal Commission and trust of financial services organisations.

prospa

The Fund will create a more diverse and competitive finance market; and bring forward capital market acceptance of the small business unsecured loan asset class by 2-3 years. This would be achieved by significantly increasing volumes of loans delivered, creating a track record with a statistically significant data base that the debt capital market participants are seeking as a prerequisite to their participation as fixed income investors.

Mandatory holding of a rating for participants would create an independent and highly credible accreditation model. In terms of players we believe there are a handful of players with scale and proven track record. Any track record is currently being being established with the use of equity and expensive debt capital. Those participants with scale have the credentials to support this initiative, having the requisite governance and infrastructure to ensure the return on funds reflects the underlying credit risk.

As such we strongly believe that the Fund is the appropriate strategy for the Government to implement its policy objectives and will:

- Accelerate the process of attracting efficient private capital to the unsecured small business lending asset class
- Not require the government to provide a guarantee of any type;
- Not commit Government resources for a materially long period of time ie less than 5 years
- Provide for an orderly exit for the government once its policy objectives are achieved.

We believe that Prospa could exponentially accelerate its funding profile to small business using the proposed ASBF structure, [redacted]

We note that in a multi-stakeholder arrangement such as the Fund, building consensus amongst the stakeholders will take time. However, the consequential benefits for Australian small businesses are exponential. As such, it is strongly recommended the process is undertaken with a tight timetable with the participation/representation from various stakeholders including Treasury, the super funds, rating agencies and fintech platforms.

The economic impact of Prospa lending and the Fund

[redacted]

[redacted]

[redacted]

[redacted]

How the Fund works

A five year time frame for the program is in line with the RMBS initiative in 2008; and noting the short term nature of small business lending (typically <3 years), would result in an efficient exit for the Government from the program and potentially without the need to rely on auctioning the securities.

We believe it is important for platforms that are given access to the Fund to meet financial, governance and behavioural standards to protect the Government's reputation as well as the funding, for example: setting mandatory access parameters such as:

- Signatories to an industry code
- Membership of AFCA
- Minimum tenure (time in market)
- Minimum loan book size (experience)
- Evidence of loss rates
- Experience with rated vehicles and /or a rating.

Cost of Capital

In order to arrive at the appropriate return for Government, it is important to acknowledge the return Prospa currently pays incorporates significant arbitrage for investors who are taking advantage of the lack of supply of capital and increasing demand for capital from issuer such as Prospa. For example, the current return being extracted by market participants for a specific credit rating for unsecured business loan, versus the market rate for a similar rated ABS paper issued off the back of unsecured receivables such as credit card, is significant, and represents the arbitrage being extracted by the limited investors.

As such Prospa believes the appropriate return for Government will be the return for a similar rated ABS paper by a credit card portfolio adjusted down for any specific benefits the state may seek to drive economic impact.

Risk rating and loss position

Prospa has worked tirelessly to establish risk rating criteria for its securitisation platform and issuance. The criteria follow the traditional approach to "tranching" securitisation notes; and are complemented by Prospa having obtained a rating for one of our issuances to create the benchmark for our portfolio. This is unique to Prospa and as such should not be considered relevant for other market participants. The size of the tranche will be subject to discussion with AOFM in terms of its appetite to participate in Prospa's program.

Prospa has always held the first loss position in all its securitisation issuance. We do not anticipate a change in this position in the medium to long term.

Timing of funding and exit strategy for Government

The concept of having more funds available upfront is driven by two factors (a) injecting capital in the earlier years will help create a balance in the demand supply equation and (b) over time with the crowding in approach being contemplated by the state, it would appear logical that there would be more market participants in the outer years so the demand supply gap will be smaller. A slower release of funds would be counter-intuitive to the agenda of the state to drive economic impact through the small business economy in the near term. We note that unlike the previous RMBS initiative, given the shorter term of the underlying assets, the State can withdraw progressively after 5 years and not having to wait for another 25 years to receive the investments.

The role of the AOFM

We believe that the AOFM has the right understanding of the securitisation market having previously supported initiatives in the RMBS market. Given the core knowledge exists, our view is that by assessing opportunities on a case by case basis, AOFM will be able to invest based on the merits of each opportunity. We do not see the need to over-engineer the approach to market if proven operators are partners of choice to deliver this initiative.

Use of Fund to deliver other economic development outcomes

Prospa would caution against prescribing how the Fund money is disbursed, for example to help indigenous business, or business in an area with low economic development due to withdrawal of Government subsidies, or to specific sectors. We believe any restrictions on the application of funds will drive distorted risk spread and potentially higher losses and would need careful consideration.

Prospa has a proven ability to assess small business risk and deliver loss rates within agreed parameters.

Attaching such a condition would potentially require Prospa to consider the impact on our first loss position in the trust. We would not wish to see any outlier loss rates attached to prescriptive loan deployment impacting on the rest of our portfolio and other funding arrangements. More importantly, prescribing how money is disbursed will impact the ability of the Fund to solve the core problem of driving volume and data about proven (low) loss rates and thereby solve the lack of funding diversity in the long term.

However, we would be happy to report on any specific data sets to government – as a fintech we know and can leverage the power of data/insights and this can inform future government policy in these areas.

Additional strategy for consideration - RBA Repo Eligibility

Prospa suggests the Committee consider amending the RBA Repo Eligibility Criteria to accommodate Rated ABS issued to fund unsecured small business loans.

The combination of the current Repo Eligibility Criteria and Rating Cap limits the ability of debt capital market participants to purchase the notes from ABS programs that fund unsecured small business loans.

As such if Treasury can work with the RBA for the inclusion of A-/A3 (sf) or higher and P-2/A-2/F3 (sf) or higher rated ABS Notes that fund unsecured small business loans, as repo eligible securities, it is likely to drive investor interest into the segment.

In our view, this initiative will in itself attract debt capital market participants whose mandate is linked to holding liquid investments (e.g. domestic and foreign bank treasury desks) – we estimate this market to be ~$1bn+

Conclusion

In conclusion it is our view, based on our experience to date - both as a lender to Australian small businesses and our experience in the debt capital markets – that the Fund will significantly accelerate the supply of private debt capital into the Rated ABS market for unsecured small business in the short to medium term.

This will provide the necessary impetus required by the segment to deliver the Federal Government's policy objectives.

The Prospa management team is committed to assisting the Federal Government in this critical policy driven initiative and willing to invest substantial time with the key stakeholders to bring this to life in a timely manner.

Yours sincerely,

Beau Bertoli

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