Submission to

The Senate Economics Committee

on access of small businesses to finance.

From Patrick J Byrne
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About the National Civic Council

The National Civic Council is a nation wide social movement with five primary principles:

- **The integrity of the human person;**
- **The extended traditional family as the corner stone institution of society;**
- **Subsidarity, or decentralism of political, economic, union and business power, decentralisation of population to give people maximum decision making over the own lives;**
- **Defence of Australia's strategic and economic independence (sovereignty), including greater self-reliance in investment capital;**
- **Traditional values that underpin these principles, providing social cohesion to society.**

The NCC operates across Australia. It publishes a two-weekly magazine, *News Weekly*.

The NCC was founded in 1942 by the late BA Santamaria and has had long involvement in the political, social and economic affairs.

The Global Financial Crisis (GFC) has left major risks in the world economy, with hazards for the Australian economy and the Australian banking system. These revolve around the heavy reliance of the Australian economy on offshore borrowing.

There are several major risks.

First the heavy borrowing by the governments of the major economies for bank bailouts (US$9 trillion by US and European governments) and more for stimulus packages, risks forcing up interest rates world-wide. The first borrowers to suffer from a credit squeeze and/or rise in interest rates will be small businesses.

Second, Australia has a very serious reason to be concerned about the likelihood of rising world interest rates.

A basic rule of banking is that banks should borrow long to lend short. Australian banks have done the opposite. Of Australia's $648billion net foreign debt, $200 billion needs to be rolled over in the next year, and $600 billion in the next four years. This warning came from Ashok Jacob, CEO of James Packer's Consolidated Media group, at a Macquarie Group conference mid last year. (*Australian Financial Review,* June 18, 2009).

Should Australian banks face a serious foreign borrowing shortage, they will be forced to substantially increase interest rates to continue foreign funding needed to roll over their foreign debt, let alone continue borrowing overseas to fund to Australian businesses. (See Appendix 1 for current concerns about future interest rates for London's *Financial Times*.)

Third, the warning of Warren Buffett to nations heavily dependent on foreign borrowing should be a wake up call to Australia, with its heavy dependence on overseas capital. Buffett warned that countries that excessively depend of foreign borrowing, risk losing their sovereignty, being "colonised by purchase rather than conquest." (*Fortune* magazine, October 26, 2003)

SOLUTIONS

Recommendation: Australia should be following the examples of other nations by establishing a development bank to provide a variety of specialist lending purposes, including lending to small businesses and farmers. Further, the bank can act as a financial safety net for the nation, in the event of a tightening of credit on world markets.

UK expanding Post Office lending and mutual funds

The UK government has just announced that it is expanding its Post Office into lending more widely into the housing market and that it intends to expand mutual funds to widen consumer choice because of deep distrust of the commercial financial markets in the wake of the GFC.

"Its plans include the launch of a children's savings account, a partnership with credit unions to offer affordable credit and a new first-time buyer mortgage, with a 90% loan-to-value ratio.

“The Post Office also announced it intends to increase its lending substantially, aiming to double the value of its mortgage book in the financial year 2010/11.

“The Post Office will receive new Government funding of £180m, beyond the £1.7bn that is already invested. The Government will also consult on a new community levy to be funded by retail banks to support the link between credit unions and the Post Office.” (‘People’s Bank’ must not distort competition, UK Building Societies Association, March 31, 2010, www.bsa.org.uk/feature/post_office.htm)

The British government has also just announced a major expansion of mutual funds. It argues that mutualism will be at the forefront of its vision for Britain’s future.

In the report, *‘Mutual Benefit: giving people control of public services’*, the Government sets out how it will accelerate opportunities for mutuals to develop and flourish across three key areas of public services.□ □Commenting on the plans, Tessa Jowell MP, Minister for the Cabinet Office, said:

“This is the moment for mutualism. In the wake of the global financial crisis and the parliamentary expenses scandal, it is clear that people are no longer prepared to trust large organisations over which they have no control. This is particularly important as we are talking about services that are of such great significance in the personal lives of the people that they serve.

“In the future, mutuals will play an increasingly important role in delivering public services. Mutual organisations are controlled by their members; they are exceptionally well-suited to strengthening relationships between staff, users and the wider community – and these stronger relationships will lead to better outcomes for all.”

“The Government paper puts forward plans for:

- new and improved opportunities for tenants to manage their own homes and housing services;
- the opportunity for local areas to pilot ways of running Children’s Centres as part of local mutual federations;
- improving the sustainability of User-Led Organisations that explore ways for communities to have a formal role in the governance of employee-led social enterprises that spin out of the traditional public sector.”

(‘Mutualism’ to offer next step for public services, UK Building Societies Association, March 31, 2010, http://www.bsa.org.uk/feature/mutualism.htm

Germany’s development bank, the Kreditanstalt für Wiederaufbau (KfW) .

The KfW was established in 1948 as a corporation under public law. In 2007 it had a balance sheet of €354 billion (A$725 billion), making it one of Germany’s 10 biggest banks, employing 3,800 staff.

The KfW supports the German economy with tailor-made financing, acting as an "equaliser" in providing low-interest, long-term credit, with repayment-free periods for smaller businesses whose sole credit option is the local branch of a major bank. This gives smaller German firms a competitive edge with foreign competitors.

Loans are granted directly to buyers, banks, investors or project companies. Borrowers may choose between loans in Euros or US dollars or other foreign currencies and between fixed or variable interest rates.

KfW Loan Programmes: KfW promotes the German economy by extending long-term loans at favourable interest rates. The focus is on financing:

- business investment and investment in environmental protection by small and medium-sized enterprises (SMEs) in Germany;
- business investment by SMEs outside Germany;
- technology, innovation and equity participations;
- the creation and modernisation of housing;
- communal infrastructure investment.

The advantages of this financing system include:

- long-term loans with a maturity of 10 to 20 years;
- favourable interest rates fixed for 10 years, and even 20 years under the SME Programme;
- a particular advantage is that almost all KfW loans can be repaid fully or partially in advance of maturity and free of charge;
- simple application, loan commitment and loan handling through a regular bank.

Export and Project Finance: In international competition, obtaining a contract often depends on the ability to offer attractive financing to the foreign buyer. KfW extends long-term loans for exports of German enterprises and for projects in Germany and abroad in which Germany has considerable interest. KfW, mandated by the legislator to promote German exports, has been active in export and project financing for almost 40 years. KfW administers different official financing support schemes for export finance.

Australia’s former Commonwealth Development Bank

The Commonwealth Development Bank (CDB) disappeared with the sale of the Commonwealth Bank. Yet, in its 30-year history, it helped establish over 400,000 small and medium-sized enterprises (SMEs).

In its early years, the CDB was heavily involved in financing farmers who took up holdings in the Ord River project, the Esperance Land Settlements Scheme in Western Australia, the Coleambally and the Heytesbury Scheme in Victoria, to name only a few such projects.

It originated out of the findings of a 1935 royal commission which found that there was a distinct lack of facilities for fixed and long-term borrowing. This was of particular importance for rural borrowers. Often it was considered difficult for a small farmer to obtain long-term credit on reasonable terms.

This led to the formation of the Mortgage Bank department of the Commonwealth Development Bank (CDB) in 1943, lending primarily to farmers at 4% for up to 20 years and 4.125% for 21-40 years. This evolved into the Commonwealth Bank in 1959. It loaned on the prospects of success, not the value of security.

As security was not the primary consideration in CBD’s lending, the raw materials upon which the Bank worked were:

- The person – his/her integrity and managerial capacity;
- That person's financial position – his/her assets, liabilities (with their repayment implications) and equity in the venture.

The CDB was staffed by experienced lenders capable of assessing the long-term feasibility of proposals. The staff included specialists in agricultural science, economics, management, accounting, and engineering. They spent much of their time in the field undertaking assessment and investigation work.

ADVANTAGES OF A NEW AUSTALIAN DEVELOPMENT BANK

First, current overseas experience shows that an alternate bank is needed when the crippling debts of commercial banks result in businesses of all sizes being unable to borrow, even to obtain overdrafts. In other countries suffering a sharp credit squeeze, businesses are laying off staff**.** This cuts tax revenue, increases the welfare bill, forces governments into deficit budgets and depresses other asset markets, causing further write-downs of bank assets. All this contributes to a negative, downward economic spiral.

A development bank could assist with, or take over, such lending in the event of a credit squeeze in Australia.

A government-backed development bank could have several departments with particular specialist functions for any combination of:

(a) lending to small business, farmers and home mortgages;
(b) development of major commercial industries;
(c) federal infrastructure works;
(d) funding to state projects;
(e) rolling over foreign debt.

Funding could come from any combination of:

- direct federal and/or state government seed injections, as the UK government is doing in the expansion of its Post Office and a lending agency;
- government-issued bonds, which could be granted a favourable tax concession on earnings;
- commercial borrowing at favourable rates, as the bank would have a AAA-rating as a government-backed bank;
- in this vein, tapping superannuation funds to provide guaranteed returns at a time when they want to reduce their exposure to shrinking markets and toxic assets;
- the Commonwealth Government future fund;
- Reserve Bank lending.

Second, it can fund the capital side of any stimulus package without adding to budget deficits, while developing the nation and securing Australia's economic sovereignty. Capital investment would be off the balance sheet of the government.

Third, it offers the federal government a wider range of options for managing the

financial sector. For example, should any Australian bank be in difficulty, the development bank could assist the government with solutions.

Put another way, in the face of the worst market failure since 1929, good economic management should include a focus both on anticipating what further systemic shocks could threaten Australia's banks and on constructing new safety support structures to keep the financial system and the economy functioning in the event that further financial shocks seize up the availability of commercial bank credit. Gone are the days of leaving all financial operations solely to the markets.

Such a bank would provide many options and advantages to the federal government:

1. Part of the bank's charter could be to target investment to domestic hard industries with long-term growth prospects that commercial banks would not necessarily fund, industries that have high economic multipliers into the domestic economy. It would be a way to provide patient capital, which would underwrite the recovery.

2. It would provide the government with its own banking institution to provide transparency on the operations of the commercial banking sector, vital to managing the Australian financial system and to heading off future crises.

3. In some areas it could help the government set necessary standards and disciplines on the banking sector that cannot be achieved through regulation alone. For example, in the area of mortgages and some commercial areas, it would make it more difficult for the commercial banks not to be competitive on loans for mortgages, small business and farmers.

4. It would provide a vehicle for the long-term funding of major industries, especially those that are strategically important for preserving the nation's sovereignty in the face of the new financial and trade Mercantilist policies of rapidly emerging world players like China.

5. It would help keep credit flowing to businesses, farmers and for mortgages, should the commercial banks be forced to restrict lending. Under such a scenario, development bank loans would support investment, support employment, support taxation revenue levels and keep down the welfare bill.

6. It would reduce the demand for deficit budgets and large stimulus packages. This would allow the government to maintain a high credit-rating, thus preserving the government's best possible borrowing capacity. By taking on government capital expenditure, it would help to separate government recurrent and capital expenditure.

7. It could possible replace the first home buyers grant, the bank could lend at a low interest rate for long-term repayment, and, if there was a concession/requirement for building new homes, it would boost the stock of available housing.

8. A development bank could provide a conduit for superannuation fund investment into areas of the economy that the superannuation industry has so far been unable or unwilling to provide. Such investments would reduce Australia's reliance on foreign borrowing, strengthening Australia's economic sovereignty. This would help

correct huge structural economic imbalances in the economy. Australians have around $1.1 trillion invested in superannuation, while Australia's commercial banks are the major borrowers of the nation's $648 billion net foreign debt ($1.2 trillion gross foreign debt), for which the government has effectively taken direct responsibility through its guarantee of bank deposits.

9. This process would also provide the super funds with options for repatriating offshore investments from declining markets, including markets that have become high-risk/toxic.

10. It would be a timely institution that could be useful for purchasing strategically important commercial and strategic assets.

11. In financially troubled times it could finance industries suffering from a temporary downturn, companies that would otherwise have to shut down and lay off workers.

Australian businesses need a new financial institution safety net, a development-style bank tailored to Australia's financial needs. It would fill a major gap in the market not catered for by commercial banks, offering many advantages to the federal government.

APPENDIX 1

'Canary in coal mine' heralds bond trouble

By Gillian Tett

Financial Times: March 29 2010 19:45 | http://www.ft.com/cms/s/0/ee2c32f8-3b5c-11df-b622-00144feabdc0.html

In recent years, a key axiom that every investment manager learnt at school (or, more accurately, in an MBA class) was that the rate at which triple A-rated countries such as America could borrow money could be labelled the "risk-free" rate – and corporate (and) other borrowing costs could be measured against it.

But is it time to rethink that "risk-free" tag? If you look at what is happening in the US and UK interest rate markets right now, the answer is "yes". From time immemorial, it has been taken as self-evident that the swaps spread in debt markets should be "positive". What this so-called "swaps spread" essentially measures is the cost of borrowing funds in the Libor market (for a private companies, such as banks), minus the cost of raising government debt.

And, since the private borrowing costs are influenced by credit and counterparty issues (ie: whether banks default or fail to repay), logic suggests those Libor rates should be higher than sovereign borrowing rates.

After all, triple A-rated central government is supposed to the safest thing about. But now, as my colleagues Michael Mackenzie and David Oakley first reported two weeks ago, something bizarre is going on. Back in late 2008, after the collapse of Lehman Brothers, the 30-year swap spread turned negative, when the markets froze amid wider financial chaos.

At the time, that swing did not grab many headlines, partly because the 30-year market garners little attention in the US. However, last week the closely watched – and vastly more influential – benchmark 10-year swap spread turned negative too, as 10-year Treasury yields spiralled up towards 4 per cent and above the 10-year swap rate.

That may simply be a temporary aberration. After all, the swaps market is not a perfect barometer of macroeconomic conditions and some unusual supply-demand imbalances seem to be distorting the market.

One issue affecting spreads, for example, is that investors are changing the way that they hedge mortgage rate risk, since the Federal Reserve is due to stop buying mortgage backed securities on Tuesday. A second factor is that more pension funds are trying to use swaps for meeting long-dated liabilities, rather than commit capital to buying bonds, at a time when government bonds are losing their scarcity value because of massive issuance.

At the same time, a flood of corporate issuance has left an unusually high number of entities swapping their fixed liabilities for floating exposures. More importantly still, there are rumours that some banks and hedge funds have recently suffered losses because they were wrong-footed by the swap swing. If so, they may be trying to cut their positions, thus exacerbating market movements.

However, there is another, less benign explanation for what is going on: namely that what we are seeing is a "canary in the coal mine" (to use the pithy image used by Alan Greenspan, former Fed chairman, last week), heralding future government bond market trouble and investor panic.

Think back, for a moment, to the early summer of 2007, or just before the start of the subprime meltdown. Back then, it was not the equity and credit markets that signalled disaster. Instead, the main sign of spreading investor alarm was that prices started to swing in the more obscure world of credit derivatives indices (such as ABX) and asset-backed commercial paper (ABCP).

This time round, is the swaps market another version of, say, ABX? Perhaps not yet. Personally, I will be astonished if countries such as the UK and US entirely avoid a government bond market shock; but I also suspect that this will occur some time down the road.

Nevertheless, if nothing else, the swaps spread swing does suggest that some investors are getting jittery. It also serves to underline that we do not live in “normal” markets right now. While the surface may look calm, the inner cogs of the financial system have been distorted by government intervention in ways that are still barely understood.

That, coupled with spiralling levels of government debt, has the potential to cause all manner of investment assumptions to go awry. Some trading desks and hedge funds are probably already counting the cost of that; as I noted above, the swaps spread swing has almost certainly created losses somewhere, given that it was not factored into most trading models.

But the story is unlikely to stop there. If we are moving into a world where government debt is no longer automatically deemed “risk-free”, partly because it no longer has any scarcity value, this will be a different world to the one investors know. In the months ahead, in other words, investors and politicians had better keep watching this swaps “canary”. Especially (but not exclusively) in the ever-expanding Treasuries world.

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