Chapter 6

Small business finance

6.1 While most public, and particularly media, attention on banking focuses on home loans, ensuring there is adequate competition in the provision of appropriate credit to small business is also important. Small businesses employ about half the Australian workforce and, unlike larger firms, are generally reliant on financing from domestic lenders.

6.2 As the Committee produced a report into access of small businesses to finance only in June 2010, and the Joint Committee on Corporations and Financial Services recently reported on its an inquiry into 'Access for Small and Medium Business to Finance'; this topic is not pursued in greater depth in this report.

6.3 Some witnesses and submitters believe that reduced competition in the banking market has hurt small business in particular:

> …the exit of non-bank lenders and foreign banks has meant that small business owners have had to adjust their business strategies. This has involved delaying plans for expansion, downsizing or, in some cases, closing an otherwise viable business. Many niche finance products, such as fit-out finance, which is relied on extensively in the retail sector, simply no longer exist...The question before this committee is whether... people who have credible cases for access to business finance are being denied because of risk rating by the institutions. Our concerns…are that businesses with a long history of relationships with their institutions are being denied applications for credit even in profitable circumstances…The overwhelming evidence is that banks have gone beyond what is reasonable…[1]

> In March 2010, CPA Australia ran four round table events with members involved with small business to gauge their views on small business access to finance. Many participants stated that they have seen a reduction in competition between lenders to small business since the beginning of the global financial crisis.[2]

6.4 In some cases it is claimed that healthy small businesses were suddenly subject to additional onerous requirements:

> In their minds they were meeting all of the criteria that were set by their lending institution. However, their loan arrangements have been reviewed by the bank and, accordingly, they have had to either turn an interest loan

1 Mr Richard Holyman, Deputy President and Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, pp 108 and 113.

2 CPA Australia, *Submission 82*, p 3.

> into retiring principal amounts or they have had other aspects of the loan changed significantly to the detriment of their plans.[3]

6.5 This accords with the views the Committee heard during its inquiry last year:

> A strong consensus emerged from small businesses across industries that competition had declined and was now inadequate among lenders.[4]

6.6 Some submitters have suggested that credit was cut to small business in an unduly harsh way during the GFC:

> Through the GFC banks reacted negatively to SME Borrowers by reducing LVR parameters and at times without notice or little notice to existing SME borrowers even when an existing borrower had an unblemished credit history, and increased serviceability requirements for new SME borrowers and imposed much lower than historic LVRs to be geared... in some cases the reduction in the LVR meant that SME Borrower/s had to find significant amounts of cash to reduce debt or they would be placed into default without cause of a poor repayment history.[5]

6.7 There are suggestions that a fear of banks deterred small business from seeking finance after the GFC:

> …given the widespread perception as well that it is difficult to obtain finance, many small businesses stopped approaching their banks. One reason is they did not want their loan facilities re-rated and end up paying a higher margin. The more they can stay away from the bank the better.[6]

Availability of credit to small business

6.8 Lending to small business slowed since the GFC (Chart 6.1). The data do not suggest lenders have discriminated against small business. Credit to small business has been increasing, albeit at a slower rate, in recent years while there has been an absolute fall in credit provided to larger firms.[7]

---

3 Mr Nick Behrens, General Manager, Policy, Chamber of Commerce and Industry Queensland, *Proof Committee Hansard*, 4 March 2011, p 60.

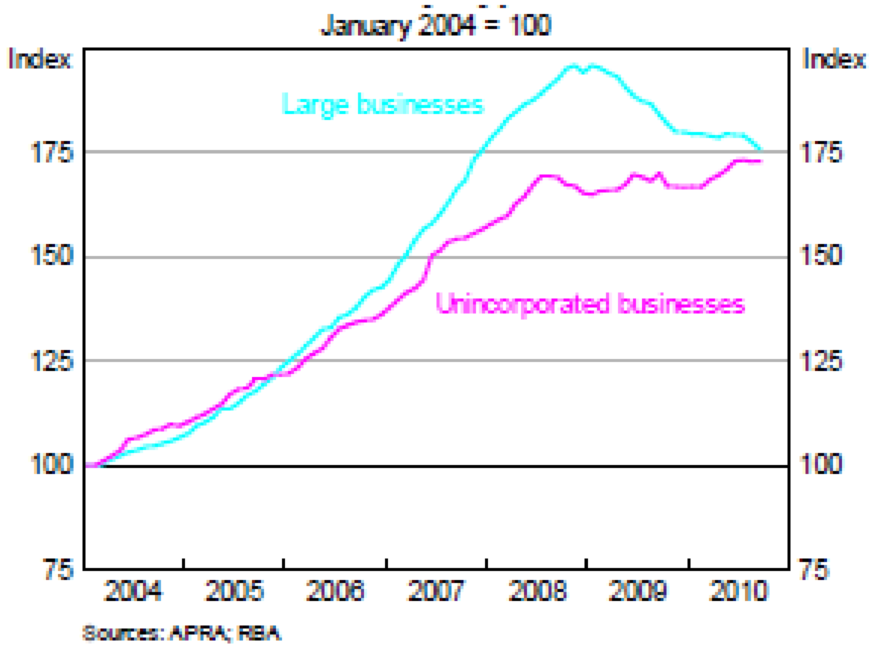
4 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 37.

5 Finance Brokers' Association of Australia, *Submission 133*, p 5.

6 Mr Greg Evans, Director of Economics and Industry Policy, Australian Chamber of Commerce and Industry, *Joint Committee on Corporations and Financial Services Hansard,* 2 March 2011, p 10.

7 This is consistent with the observation that while bank business loans of less than $2 million *slowed* during the GFC, there was a *fall* in the amount of larger business loans outstanding; Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 8.

Chart 6.1: Business credit by type of borrower



Source: Reserve Bank of Australia, *Submission 41*, p 7.

6.9 The Committee examined the reasons for this last year, concluding:

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

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

and supply factors such as;

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

Witnesses were reluctant to apportion the roles played by these various factors.[8]

8 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 1.

6.10 The Reserve Bank suggest:

> It appears unlikely that credit growth will return to the very high rates that were sustained in the pre-crisis period, since credit expansion during that period was significantly boosted by the one-time adjustment to financial deregulation and the shift to low inflation… There have been no notable changes in lending criteria at the smaller end of the business loan market.[9]

6.11 Another factor mentioned as possibly restraining lending to small business is the capital backing required to underpin it by rules set by APRA. These are discussed further in Chapter 11.

Sources of credit for small business

6.12 Small business is largely reliant on the major banks for its funding. Foreign banks and smaller lenders are unlikely to compensate for reduced competition between the major banks:

> …experience shows us that foreign lenders are mostly interested in corporate lending and lending to particular sectors such as commercial property development...Second tier lenders (smaller banks and credit unions) …without larger distribution networks and larger back office support…[are] unlikely…[to] become a major source of competition in small business lending.[10]

6.13 There may be scope for mutuals to lend more to small business, especially as mergers increase their size. Already, Credit Union Australia, the largest credit union, reports over 20,000 small business customers.[11]

6.14 The WA Small Enterprise Network was particularly concerned about the implications for young entrepreneurs of banks' reliance on mortgages on homes to secure small business loans:

> … the relative cost of a house measured against average weekly earnings is significantly greater than it has been in the past. As such, it is becoming more difficult and costly for the younger generation of Australians to enter into home ownership. As a result, it is possible that by the time future entrepreneurs have purchased a home and built up sufficient equity to act as collateral against a business loan, they will be on average older than is the case now. They may be past the current average age where people currently seek out finance to start their own businesses.[12]

---

9 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 27.

10 CPA Australia, *Submission 82*, p 9.

11 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 88.

12 WA Small Enterprise Network, *Submission 68*, p 8.

The cost of credit for small business

6.15 Even if small business is able to access credit, a lack of competition may manifest in credit being unduly costly. Since the GFC, finance for small business has become more expensive, both absolutely and relative to housing loans (Charts 5.6, 6.2 and 6.3).

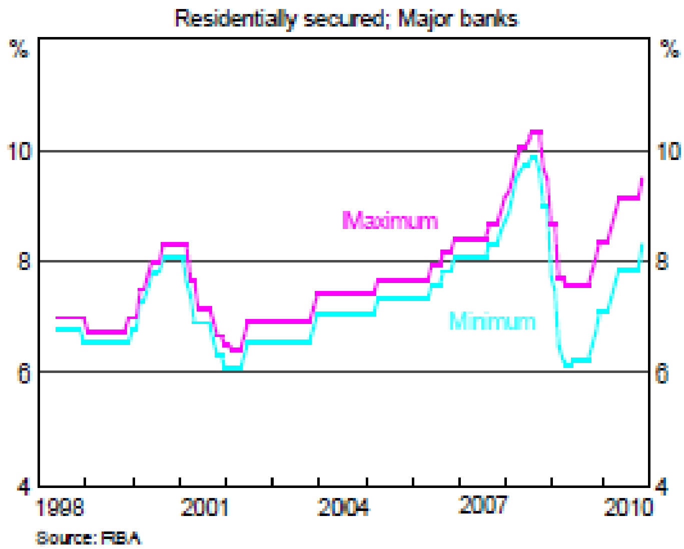
6.16 The banks offer three justifications:

> …(a) small business loans are riskier and so attract a higher risk-premium than residential housing loans; (b) the margins being charged before the GFC were too low and the higher margin today reflects a more appropriate rate, and (c) higher levels of capital are required for small business loans (compared to housing) as part of the prudential regulatory regime.[13]

6.17 As noted above, lenders are paying more attention to the risk in loans. This has led to a wider range of interest rates being charged to borrowers. (Chart 6.2). But while banks may be more cognisant of risks, this does not mean the riskiness of their small business loans has increased (compared to pre-GFC levels; risk certainly goes up during a recession). Indeed to the extent banks are being more selective in their lending the average risk of their loans should have been *lowered*:

> …if they are lending to the less risky businesses, the aggregate risk that they bear should have reduced and that should in turn result in them being able to lend at a lower cost than would otherwise be the case.[14]

Chart 6.2: Range of indicator rates for small business variable rate loans



Source: Reserve Bank of Australia, *Submission 41*, p 18.

13 Australian Bankers' Association, *Submission 76*, p 39.

14 Mr Micah Green, Economist, New South Wales Business Chamber, *Committee Hansard*, 21 January 2011, p 56.

6.18 The Committee heard that small business is increasingly reliant on expensive credit cards for financing:

> …63 per cent of small and medium business owners are now using their credit card facility as a form of business finance. That is extremely high by international standards…[they are paying] extremely high rates…[15]
>
> Increasingly for small business their primary means of finance is through credit card facilities.[16]

6.19 Banks have been criticised for charging more for a small business loan secured against a residential property than for a home loan secured against the same property:

> We can see no reason why a fully secured business loan should attract a higher interest rate than a housing loan similarly secured. We suggest that one way of addressing this issue would be to add a properly drafted anti-price discrimination clause to the *Trade Practices Act* which could, among other things, prohibit differential pricing of loans and other financial services unless it can be demonstrated that costs or risks attached to these are different.[17]
>
> So it is very difficult to justify an interest price premium when the ultimate asset that is being used to balance it is the same.[18]
>
> The loan of funds for use in the operation of small businesses is unjustifiably subjected to higher rates of interest and more arduous conditions than loans made to other customers who provide the same security…Given that this practice is common across all banks it has the appearance of being collusive behaviour.[19]

6.20 The banks responded:

> …you have to look through the security. The security is not something you should be relying on. The security is there and it is an important component, but you have to look through that to the underlying fundamentals of the business, particularly the ability to service the debt… It is timeliness as well. In a business situation it could take quite a bit of time to unwind security, or you have to have a business plan prepared to see whether the business can trade through and so you might be working against a couple of scenarios for a while. So there is a timeliness element to it, and then there is cost of recovery…The long-run loss profile on those

---

15 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, p 111. CPA Australia provide further information and show this is a higher proportion by international standards; *Submission 82*, p 5.

16 Chamber of Commerce and Industry Queensland, *Submission 43*, p 9.

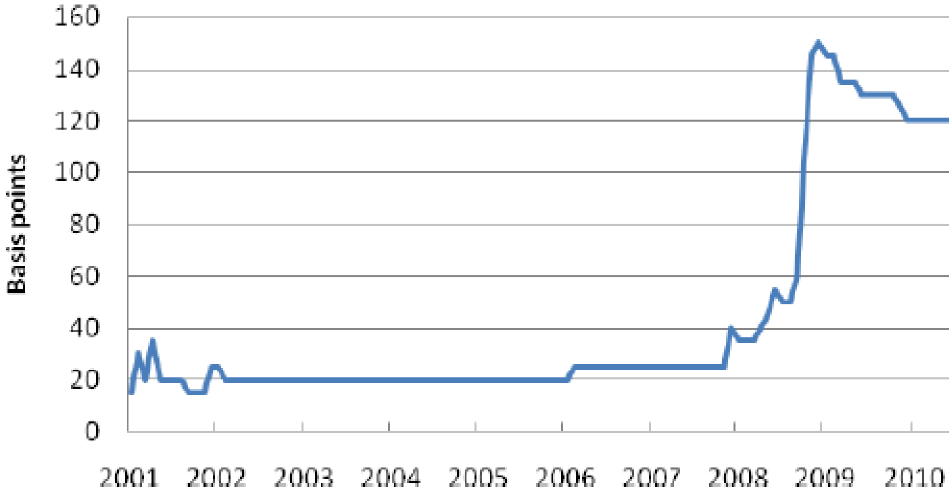
17 National Association of Retail Grocers of Australia, *Submission 54*, p 2.

18 Mr Andrew Canion, Manager, Western Australian Small Enterprises Network, *Committee Hansard*, 21 January 2011, p 115.

19 Council of Small Business of Australia, *Submission 90*, p 3.

loans is higher than normal residential secure mortgages, and that will drive the risk profile, that will drive the cost.[20]

Chart 6.3: Spread between small business and home loan rates



Source: NSW Business Chamber, *Submission 84*, p 10.[21]

6.21 The Australian Prudential Regulation Authority supported the banks' view:

> The underlying default rates and arrears rates on owner occupied homes and investor lending is a lot lower than it is for small and medium sized enterprise loans that are secured against the residential mortgage. They have a far higher likelihood of what they call 'probability of default rates' and 'loss given default' than do the normal residential mortgages.[22]

6.22 The Reserve Bank quantified these differences:

> The interest rate must cover the expected loss of making a particular loan. The expected loss is, in turn, largely determined by a borrower's *probability of default* and the *loss given default*. In the first case, rough estimates suggest that small business borrowers are more than twice as likely as standard mortgage customers to default [Chart 6.4]. In the second case, once a default has occurred, APRA statistics suggest that a lender is

---

20 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, pp 53-54 and 67. A similar argument was made by Mr Peter Hanlon, Group Executive, People and Transformation, Westpac, *Proof Committee Hansard*, 21 January 2011, p 87.

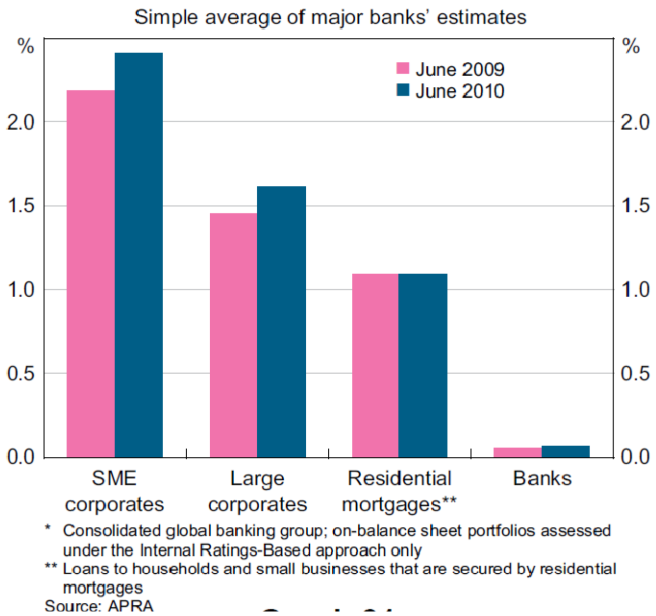
21 A longer run version of this chart is given in Westpac, *Responses to questions on notice, no 16*, 7 March 2011, p 3.

22 Mr Graeme Johnson, General Manager, Supervisory Support Services, APRA, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 19.

likely to lose close to 30 per cent of the small business loan's value, compared with 20 per cent for housing loans.[23]

6.23 As the default rate on home mortgages is around 1 per cent, this would imply the interest rate on small business loans should be around 50 basis points higher than for housing loans.[24] This is more than the difference in interest rates charged had been for most of the past decade but less than the current difference (Chart 6.3).

Chart 6.4: Probabilities of default



Source: Reserve Bank of Australia, *Financial Stability Review*, September 2010, p 22.

6.24 This is consistent with the response when Westpac was challenged about why the differential was previously so much lower:

> …we have seen banks losing more money than they would like to on small business because of the mispricing for risk.[25]

6.25 The inquiry by the Joint Committee on Corporations and Financial Services reported last month that:

> On the basis of the evidence submitted to the committee, it appears there are sound reasons for the higher interest rates for SME loans compared to residential loans, and the increased cost of SME lending that resulted from the GFC.[26]

---

23 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 8.

24 The difference between the required margin on housing loans of 1 per cent x 0.2 = 20 basis point and 2.4 per cent x 0.3 = 72 basis points.

25 Mr Peter Hanlon, Group Executive, People and Transformation, Westpac, *Proof Committee Hansard*, 21 January 2011, p 87.

26 Joint Committee on Corporations and Financial Services (2011, p 30).

Loan guarantees for small business

6.26 The Australian Chamber of Commerce and Industry recommended the Government explore the feasibility of a temporary small business loan guarantee:

> There are schemes of this nature in a number of other industrialised nations— Canada, the United States, the United Kingdom—that are worthy of some serious assessment at the very least. What governments in those jurisdictions have done is to provide some mechanisms for government to provide some guarantees on small business loans where there is some clearly demonstrated market failure that is not being met by the market.[27]

6.27 This was supported by other small business representatives:

> We would absolutely, totally support it.[28]

> Master Builders recommends that government extend guarantees to small business loans.[29]

6.28 The NSW Business Chamber is concerned about the design of such a scheme, and argues it should involve a price for the guarantee and should not cover 100 per cent of the value of the loan to ensure banks retain an incentive to consider loan applications carefully.[30] They also argue that not all a bank's loans should be covered:

> For instance, if a bank had, say, 100 loans to small businesses all covered by the guarantee, you could put a cap on to say that only 10 per cent of those loans can ever be claimed against the government guarantee. So if all 100 went belly up, you would get financing back for only ten.[31]

6.29 Treasury does not support such schemes:

> The majority of OECD countries have implemented or expanded existing guarantee schemes for small business loans since the onset of the global financial crisis. However, these schemes have generally been unsuccessful in stimulating credit to small businesses. According to the OECD, such guarantee schemes and extensions have not produced the desired results, and ‘the stagnation in lending is true even of banks in countries where…credit guarantee schemes exist.[32]

---

27 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, p 110.

28 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 12.

29 Master Builders' Association, *Submission 38*, p 6.

30 NSW Business Chamber, *Submission 84*, p 4.

31 Mr Micah Green, Economist, New South Wales Business Chamber, *Committee Hansard*, 21 January 2011, p 57.

32 Treasury, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 66.

International examples of such schemes

6.30 Some small business representatives gave the following examples of such schemes overseas:

> Most OECD countries have small business loan guarantee programs, with the exception of Australia and New Zealand.[33]
>
> 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.
> - 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.
> - In the United States, the Small Business Administration (SBA) guarantees loans made to small businesses by financial institutions.[34]

6.31 The Reserve Bank provided comparative information on overseas schemes to the Committee last year.[35]

6.32 A survey by some World Bank economists made the following observations:

> Many countries around the world have therefore made Partial Credit Guarantee (PCG) funds a central part of their strategy to alleviate SMEs financing constraints. Multi- and bilateral donors have supported the set-up of such schemes around the developing world. These schemes seek to expand lending to SMEs, sometimes focusing on specific regions or sectors through reducing lending risk. Specifically, a PCG fund is a risk transfer and risk diversification mechanism; it lowers the risk to the lender by substituting part of the risk of the counterparty by that of the issuer of the PCG…PCG funds (and full credit guarantee funds) have existed at least since the beginning of the 20th century[36] and have become more popular over the past decades. In spite of their recent growth and initial evidence suggesting success of some of these funds, there is a dearth of analysis to systematically inform the process of design of PCG funds, pricing of their guarantees, their regulation, and the implication that PCG fund

33 Master Builders' Association, *Submission 38*, p 6.

34 Chamber of Commerce and Industry Queensland, *Submission 43*, p 19; New South Wales Business Chamber, *Submission 84*, p 3.

35 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, pp 69-74.

36 Uruguay established a scheme in 1896!

characteristics have with respect to the prudential regulation of banking portfolios covered by such guarantees.[37]

6.33 Their analysis leads them to conclude:

> Our survey shows an important role of government in partial credit guarantee schemes around the world, but mostly limited to funding and management, and much less in credit risk assessment and recovery. This might be for the better, as we also find that where government is involved in credit risk assessment and recovery, default rates are typically higher. Older schemes are also more likely to be government funded and managed and also have higher loan losses, consistent with the notion that the costs and liabilities of a PCG fund become obvious only after some time. We find a surprisingly low incidence of risk-based pricing and limited use of risk management mechanisms.[38]

Committee view

6.34 Last year the Committee concluded:

> The Committee notes the suggestion of a guarantee for loans to small business but prefers to increase competition within the commercial banks rather than for a government entity to assume the risk.[39]

Banks' service to small business customers

6.35 In last year's inquiry into banks and small business, the Committee observed that:

> A number of submissions referred to customer dissatisfaction with banks' services to small businesses, including claims about unreasonable increases in interest rates, poor communication and changes to loan conditions made unilaterally without notice.[40]
>
> There are suggestions that as banks become larger the quality of service to small business may decline, particularly if duplicate branches are closed and local managers moved.[41]

6.36 There was also concern that branch bank managers no longer had the experience and familiarity with local business conditions to make well-informed credit decisions and sometimes lacked the authority to take such decisions.[42]

---

37 Beck, Klapper and Mendoza (2008, pp 2-3).

38 Beck, Klapper and Mendoza (2008, p 25).

39 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 68.

40 Economics References Committee, *Access of Small Business to Finance*, June 2010, p 62.

41 Economics References Committee, *Access of Small Business to Finance*, June 2010, p 63.

> …as much as the banks have tried to present the view that they are becoming more locally focused, we are not seeing that in practice yet. What we are seeing is that a risk factor is applied to businesses fitting a certain profile across the nation, irrespective of the different business conditions. [43]

6.37 Even one of the major banks conceded there were virtues in:

> ...doing business with customers you can see from the local church spire.[44]

Code of conduct

6.38 Small business believes:

> …it is inappropriate that small business are excluded from coverage under the Uniform Consumer Credit Code…[45]

6.39 The banks have a general code of conduct but some submitters thought they ought to develop a code specifically relating to small business:

> Bank and bank client relationships have also been strained. One initiative that may contribute to improving relationships between banks and small business and reduce the possibility of this relationship being damaged again in the future, is for the Australian Bankers' Association (ABA) to consider expanding its existing Code of Banking Practice to include a code of conduct on small business lending.[46]

> …such a code is the only process by which small businesses –and other bank customers – can engage on reasonably even terms in negotiating dispute resolution. The inordinate, indeed overwhelming power of the banks and their huge financial resources simply precludes the use of the courts for all but the wealthiest of the bank's customers.[47]

6.40 Some submitters would like to see Australian banks adopt international practice in this area:

> …the UK, Canada and Ireland have specific codes of conduct relating to lending to small to medium sized enterprises and that such a Code would therefore bring Australian banking into line with best practice.[48]

---

42 See, for example, CPA Australia, *Submission 82*, pp 16-18.

43 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, p 115.

44 Mr Joseph Healy, National Australia Bank, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 54.

45 Council of Small Business Organisations, *Submission 90*, p 7.

46 CPA Australia, *Submission 82*, p 1.

47 Council of Small Business Organisations, *Submission 90*, p 7.

48 CPA Australia, *Submission 82*, p 10. CPA provided the Committee with more information about the codes in Canada and Ireland last year; see Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, pp 78-79.

6.41 The Committee called for such a code last year.[49] A further discussion of the codes of practice developed by the banks and mutuals, and lists of those intermediaries subscribing to them, are available in the report by the Joint Committee on Corporations and Financial Services (2011).

Recommendation 3

6.42 The Committee recommends that the Australian Bankers' Association meet with small business representatives to develop a code of practice specifically relating to lending to small business.

Bank mergers and small business lending

6.43 Small business may suffer disproportionately from further mergers within the banking system. A survey of the economics literature by the Committee last year found that:

> As banks become larger they are more able to make large loans to large companies. It has been suggested that this may lead to them being less interested in lending to small business. Overseas studies have found some empirical evidence that larger banks make a smaller proportion of their loans to small business.[50]

6.44 The Australian Prudential Regulation Authority observed that:

> Regional banks as a group tend to have a relatively high share of small business loans to total loans.[51]

6.45 Bank mergers are discussed further in Chapter 9.

Better information about the sector

6.46 The Committee called last year for better information about the small business credit market:

> The Committee recommends that the Government request the ACCC, APRA and the Reserve Bank to provide a joint annual report to parliament on competition in the retail banking market in Australia, and the provision

49 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 80.

50 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 50. Among studies cited were Berger, Demsetz and Strahan (1999); Carletti, Hartmann and Spagnolo (2002); Group of Ten (2001); and Hawkins and Mihaljek (2001).

51 Senate Economics References Committee, Access of Small Business to Finance inquiry; APRA, *responses to questions on notice*.no. 3, p 1.

> of finance to small business, but taking care not to increase unduly the reporting burden on financial institutions.[52]

6.47 This view was echoed by some submitters to this inquiry:

> CPA Australia recommends that the government (or its agencies) introduce a Bank Lending Survey measuring changes in demand for debt finance by business (categorised by business size) as perceived by senior bankers. Such a survey would assist government, regulators and the business community understand trends in business lending.[53]

6.48 This is the practice in some comparable economies:

> The governments or their agencies of a number of major economies (including US, UK and Canada) produce a regular Bank Lending Survey.[54]

> Currently, Australia does not have a dedicated senior loan officer survey to determine the supply and demand conditions prevailing in the small and medium-sized enterprise (SME) lending market. Such lending surveys currently exist in a number of countries including the United States of America (US), the United Kingdom, Europe and Japan, and have been useful in researching the lending demand and supply dynamics for both SMEs and large firms. For example, the US Federal Reserve issues the 'Senior Loan Officer Opinion Survey on Bank Lending Practices'.[55]

---

52 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

53 CPA Australia, *Submission 82*, p 10.

54 CPA Australia, *Submission 82*, p 10.

55 Australian Securities and Investments Commission, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 23.