Minister for Small Business

Mr David Murray AO
Chairman
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear ~~Mr Murray~~ David,

Your Inquiry has called for submissions on how Australia's financial system is meeting the funding needs of the economy.

The financial system underpins economic growth in Australia and it is the role of the Inquiry to consider how the financial system may best deliver improvements in living standards into the future. To do this, it is important for the Inquiry to ensure the financial system is delivering for end users.

Small businesses are drivers of economic growth in Australia, employing millions of Australians. They are also significant users of the financial system, as they need finance in order to set up and grow. In particular, small businesses need to have access to appropriate finance at competitive prices if they are to continue to play their important role in the economy.

Since being elected to Parliament I have spoken with a large number of small business owners and I am privileged to now represent the interests of Australian small businesses in Cabinet. My conversations with small business owners have provided an insight into the experience of small business operators and a desire to pass on their concerns about access to finance.

Competition

Small business operators across Australia have shared with me their experiences about the difficulty they have obtaining finance. Many of these experiences are ones that would not be captured by official statistics on loan acceptance or rejection rates, with some small businesses not applying for loans because the process is too confusing or time-consuming. A NSW Business Chamber report indicates that this experience is widespread, with 20 per cent of survey respondents who reported needing finance not applying for loans as they found the process too difficult.

For those small businesses that do apply, Australian Bureau of Statistics data indicate that loan applications are rejected at roughly twice the rate of medium-size businesses. While the official statistics do not capture it, both small businesses and the banking sector have indicated to me that the rejection rate is considerably higher for start-ups.

Where they are successful in obtaining a loan, small businesses face higher interest rates on loans than for larger business loans and for home loans. According to Reserve Bank of Australia data, the average rate on outstanding small business credit is 215 basis points higher than for larger businesses and 80 basis points above standard home loan rates.

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This gap in interest rates has widened by 65 basis points compared to larger business loans and 25 basis points compared to home loans since the global financial crisis. While default rates for small business loans rose during the global financial crisis, they have fallen from their 2011 peak without a commensurate decline in the cost of finance gap.

The terms of reference called for the Inquiry to consider competition in the financial system. Improved competition in the market for small business lending would help to drive down the cost of finance, and may potentially see banks invest in stronger relationships with their small business clients in order to keep their business.

When I met with regional banks recently they indicated that certain regulatory settings (for example allowing banks a choice between standard and internal risk-based approaches to risk weightings) are advantageous to the major banks. The Customer-Owned Banking Association notes perceptions that the major banks are 'too big to fail' have strengthened credit ratings for the major banks, placing smaller banks at a competitive disadvantage.

The Inquiry may wish to consider whether the current regulatory regime is restricting competition through its prudential regulatory treatment of banks and other financial institutions.

The question of competition in the market for small business finance is not solely about bank debt products. A wide range of innovative sources of finance may enable small businesses to access the funds they need without going to banks and without requiring small business operators to give up control of their business.

Innovative solutions including venture capital and crowd-sourced equity funding have particularly good prospects for improving access to finance for start-ups. The Government is exploring ways to develop a better ecosystem for innovative sources of finance. This includes ensuring that the regulatory settings do not unnecessarily constrain access to these products, and improving small businesses' awareness of these alternatives to bank debt.

While there is a need to ensure that investors, including retail investors, are appropriately protected while dealing with these sorts of products, I want to see these innovative sources of finance become and remain available to small businesses as alternatives to bank debt. It is important that any investor protections introduced not overly restrict access to these products.

I encourage the Inquiry to think of small business finance as broader than simply banking and to consider how to balance the accessibility of innovative sources of finance with the need to adequately protect investors.

Entrepreneurial culture

The terms of reference instruct the Inquiry to make recommendations on how the financial system may deliver efficient allocation of capital, and how it may facilitate risk-taking and risk-sharing. Small businesses are crucial to Australian economic growth and the financial system should encourage the entrepreneurial spirit of small business operators and start-ups in Australia. The financial sector has a critical role here, as entrepreneurship requires providers of finance that support risk-taking.

Small businesses feel there is a disconnect between the standardised loan application processes of most banks and small businesses on the ground. The one-size-fits-all model, in which banks consider loan applications on the basis of standardised assessments, has improved the efficiency of processing loan applications for banks at the expense of small businesses, with consideration of the application focused on how much security the small business owner can offer as opposed to the business proposition. These new models do not capture the individual circumstances of local businesses or their potential future cash flow, and as a result, information that may be relevant to the loan application is excluded.

The difficulties posed by standardised assessments are heightened for start-ups, which typically do not have a credit rating to demonstrate their ability to service the debt and are unable to provide the type of information sought for standardised bank processes. While some start-ups may be able to rely upon the personal credit history of the business owner, it is likely that centralised loan processing systems will favour existing small businesses over start-ups.

As the Inquiry looks at the challenges facing the financial system in the future, it may wish to consider the role of security for small business loans. Many small business loans are secured by the family home. By providing the family home as security, small businesses are able to access cheaper finance. Home ownership rates in Australia have fallen from 71 per cent to 67 per cent over the past two decades, with younger Australians increasingly unable to afford to buy a home. This makes it more difficult for younger Australians to obtain a small business loan, hindering potential entrepreneurs who may wish to start a small business.

Small businesses tell me that the covenants on loans can be very restrictive, therefore limiting the ability of a small business to grow. Some of these loan covenants, which may include certain regular financial reporting to the bank or limits on what the business may do with funds, have severe and disproportionate penalties attached, including potentially calling in the loan, which requires the small business owner to pay off the loan in full immediately. These penalties can cause an otherwise viable small business to fail.

The discretion afforded to banks through these covenants, and the threat they may pose to small businesses was highlighted by the Senate Standing Committee on Economics report into the Post-GFC Banking Sector in its consideration of the experience of Bankwest during the GFC.

The Committee noted that, when CBA acquired Bankwest, all secured properties were subjected to revaluations. Many property values were found to be lower than previously, meaning that the maximum loan-to-valuation ratio specified in the loan covenants were exceeded, and loans for which all repayments had been made were placed into default. The Committee found legitimate concerns in the approach taken by CBA in requiring repayment of these loans so quickly, and recommended that banks provide longer timeframes for repayment of loans in default due to covenants. I welcome the changes made in 2013 to the Code of Banking Practice extending these timeframes to ten days, although this remains short for businesses that may need to refinance.

Similar restrictions may apply to other bank debt products. For example, some small businesses have had their line of credit cancelled at short notice and without reason, even where there has been no difficulty with the business servicing its debt. These businesses are then left with just 30 days to find a new source of funding, and the owners must spend time seeking new funding instead of getting on with running their business.

Similarly, I have also heard concerns from small business operators about the propensity for banks to quickly force small businesses that default on their loans into insolvency, rather than working with the small business to get them back on track. The Inquiry could consider whether there are any regulatory or other factors that create undue incentive for banks to place small businesses into external administration over attempting to work with the business to turn things around.

These experiences of small businesses indicate that banks are reluctant to take on risk with small businesses in difficulty, and are ceasing to offer credit to small businesses rather than bear some risk and work with business owners to address their issues. The Inquiry may wish to consider whether the banks have an overly risk-adverse culture when it comes to financing small businesses.

Concluding remarks

While encouraging competition and efficiency in the financial system may assist small businesses, stability of the financial system is also important. The European experience during the global financial crisis, where lending to small business fell by up to 50 per cent, demonstrated the risk to small business finance during periods of instability. In contrast, Australian small business lending was flat through the global financial crisis.

The Inquiry's terms or reference call for recommendations that address whether the financial system meets the needs of users of the financial system, rather than focusing solely on regulated entities. Small businesses are significant users of the financial system and the Government looks forward to receiving the Inquiry's recommendations on how the needs of small business can be better met by the financial sector in the future.

Yours sincerely

BRUCE BILLSON

David,
Thankyou for the generous amount of time you afforded me to discuss these issues.
Regards, B.