ECONOMIC DAMAGE BEING DONE TO SME BUSINESSES BY THE FINANCE SECTOR

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WE CAN NO LONGER AFFORD A FINANCE SECTOR THAT IMPEDES BUSINESS GROWTH

As a SME business owner, I have great concern that this enquiry is not grasping the true extent of damage the finance sector is doing to SME business growth and hence economic growth. Australia can no longer afford the scenario where Banks continue to gouge SME business and withhold funding critical to economic growth so that they can generate profits beyond the economic capacity of Australia. Commercial lending has halved over the last 25 years and we have a financial sector with control of $3T of lazy capital that is not being effectively used to create economic growth and jobs. At the same time emerging businesses are being forced offshore to seek funding resulting in innovation and jobs going offshore. 98% of businesses are SMEs and are a critical component of the economy that employs 70% of the workforce. SMEs are a primary consumer of products and services of large corporations, directly and indirectly as well as major tax payers. Yet our policy makers, economists and regulators cannot make the connection that in financially constraining the SME sector, there is a detrimental flow on effect to the rest of the economy. This is being demonstrated by collapsing tax revenues and rising unemployment in Australia. How can SME business prosper by paying 500% to 1,000% more than the cash rate? The RBA is mystified why business is not taking advantage of low rates to invest in growth and the simple fact is that banks are not passing on the discounted rates to business. It as a matter of great urgency for this enquiry to ensure that we have a competitive and capable finance sector that can reinvigorate SME growth for the sake of the Australian economy.

The statistics used in the interim report grossly misstate the true funding demand of SME businesses and fails to reflect the true cost of SME finance due to incorrect assumptions. There is a structural economic deficiency around SME Funding that is not fully understood. The misconception is that this is an issue around security and risk, however the real issue is the total failure of Australian Financial Institutions to invest in proper systems and training to change their credit risk assessment to fit with evolving nature of businesses that are adapting to a new global economy. We mandate that Australian businesses have to adapt to globalisation, but then encumber them with credit assessment models 20 years out of date and from another economic era. Australian banking has become fat and lazy where they no longer invest the time and effort required to support the SME sector properly and this is hindering economic growth in Australia. Sadly this is not just a problem in Australia it is a problem across the globe and prompted the USA to introduce the JOBS act to try and address the lack of funding for SME Businesses. Improving access to affordable funding for SMEs needs to be a critical outcome of this enquiry so that we can reignite economic growth in Australia.

I would put to every Director of every major bank and every financial regulator in Australia to consider one issue as part of their due diligence. If 70% of mortgage payers are employed by SME business and in financially constraining SMEs those jobs are threatened, then the banks in their treatment of SMEs are threatening the serviceability of a large proportion of Australia's banking book and hence creating a serious systemic risk.

Equally they need to understand that Australia is creating a new GFC scenario by structurally withholding funding from SME Businesses. This is the fault of both the banks and the regulators in what I can only describe as bureaucratic lunacy. Current risk mitigation policies are actually causing systemic and systematic risk by withholding lending from SME business that if continues will lead to a similar economic collapse that occurred in 2008 from a credit squeeze. Australia needs to recognise that the health and viability of the Finance sector depends on the resilience of the SME Sector and hence a focus needs to be given to support a long ignored sector.

In lobbying government to create an environment that improves affordable funding access for SME Business I have been raising the following issues and I would appreciate if this enquiry could take them into careful consideration.

Observations of SME Lending is not taking into account Generational change

Many of the meetings I have attended that are reviewing SME business funding have distorted representation in that the majority of attendees   baby boomers who are in a better financial position including owning their own homes and who experience less problems borrowing.   However sit in a room of X and Y generation business owners and their experiences are drastically different.

There needs to be a focus on the next generation of business owners coming through who are in growth mode where baby boomers are in consolidation mode preparing for retirement. Australia needs to recognise that the next generation has little equity in real estate due to house prices and they have adopted business models completely different to the past to compete in a globalised economy. It is a different world that banks are failing to cope with, yet the next generation of business owners are the future of our economy.

Enquiries findings on price differential for SMEs is flawed

The interim reports findings suggest that SMEs are paying only around 200 points higher rates than corporate loans but this is not correct. The statistics fail to take into account that SMEs are largely borrowing personally and not against the company.   For instance there is over $14B on personal credit cards of business owners at interest rates as high as 20% which is substantially greater than the corporate rate.   I have spoken to some women entrepreneurs who are paying $35K for franchise fees on their personal credit card because they cannot get business loans from the banks.   This is a sad reflection of Australia's flawed banking system that is highly destructive to economic growth.

Bank's statements of 80% of SME Loans being approved misrepresents the actual situation

The reality is that rejection rates should be far higher. This is not a positive for banks, but a statistic of concern reflecting that SME business have given up applying.   Banking executives will be the first to admit that they are puzzled why small businesses are not applying for loans. Here is just another example of the impact that the finance sector is having on economic growth through the hurdles the finance sector have created.

Banks have inadequate trained staff who spend inadequate time assessing SME Loans and they base credit assessments on archaic criteria that has failed to keep pace with changing markets.   SME business owners can take days putting together a loan application showing business plans, revenue forecasts, history of income and the business financials. The banks will reject it in 5 minutes without discussion or proper investigation, so why bother.

On top of this, if business owners apply for too many loans they get a black mark against their credit rating for excessive loan enquiries. If you know that the banks are not going to bother to assess the loan properly why risk a negative credit rating by trying.

SMEs are giving up on applying for loans or alternatively at the prompting of banks are taking out personal credit cards.   Banking culture is driving business away.   It is also reflected in the RBA concerns around why SME Businesses are not taking advantage of low interest rates to invest in growth.   The key issue here, is that economic growth is going to be held back if SME Businesses don't start investing for growth and they need access to affordable finance to grow based on rational credit assessments.

> **Recommendation**:
> A banking license in Australia is a privilege that should have with it obligations to the Australian economy and community.   There needs to be an obligation by banks to ensure that they have adequate resources with adequate training and give adequate time to assess SME business loans.   It should be a cost of doing business in Australia in order to have a banking license.

Mortgage backed commercial lending is unsustainable

Banking has become lazy where the only commercial lending to SMEs is with a mortgage against the home. This is creating a perfect financial storm where 50% of small businesses are owned by baby boomers who plan to sell in the next 10 years for their retirement combined with a generation who either do not have a mortgage or if they do, they have little equity to borrow against due to high house prices. The X and Y generations will not be able to get the finances to buy baby boomer businesses under the current banking structure which will cause major economic problems over the next decade. Around 35% of Australians are employed by baby boomers who are planning to retire and there is no succession path due to financial restrictions.

We need to look at innovation in lending that finds alternative ways to manage risk than just mortgage lending. SME Businesses have been forced to adapt to globalisation, it does not make sense that the banks are persisting with credit assessment models from a past era.

Apra is giving far too lenient asset risk weighting on mortgages at a cost to commercial lending

APRA by giving asset risk weightings as low as 35% for mortgage lending to calculate capital requirements is not only questionable but it is driving a housing bubble whilst damaging commercial lending that is risk weighted at a 100%. The RBA has a quandary of having to drop rates further to encourage business to borrow, but they need to increase rates to slow property lending. Whilst APRA is rewarding banks to focus on mortgages and it is punishing banks for getting involved in commercial lending (ie banks can lend twice as much in mortgage lending than they can do in commercial for the same level of capital). Super Australia identified in research that the amount of commercial lending for every dollar of residential property lending has plunged from $3.84 to $1.62 over the past 25 years, it has more than halved.

The reality is that the GFC was caused by mortgages across the globe being of dubious asset quality. Yet in Australia we are continually promoting this fallacy that mortgages are safe bets and we are heading down the same road that the USA was pre GFC. House prices and housing affordability statistics all raise serious concerns that there is an increasing chance of a housing collapse that APRA is not doing enough to mitigate against. We have a current situation in Australia where APRA is overstating commercial risk and understating mortgage risk.

> **Recommendation.**
> APRA has to increase risk weighting of mortgage assets by at least another 20% both to make sure banks have more capital to cover a housing collapse and to encourage greater commercial lending that is desperately needed to reignite the economy. The Australian economy is too dependent on housing and we need to spread concentration risk.

Credit Card Lending to business owners has created a new problem

Banks are avoiding doing business credit assessments by lending to business owners on their personal credit cards. There is near half a million business owners with over $20K on credit cards and some over $75K on personal credit cards paying 15% to 20% interest rates They are trapped under the current credit scoring as people with high credit card balances are regarded as at risk. These business owners cannot refinance with another bank and the banks will not let them consolidate credit card debt into other forms of loans. When you hear the bizarre excuse that the bank cannot consolidate the credit card debt to a lower interest rate loan because the customer is a high risk and then a week later that same person receives a limit increase on that same credit card, you have to ask if this is conscionable business practice.

Whilst there is no doubt that there are more defaults on unsecured credit, the reality is that we are talking at the worst 3% and the banks are charging 15% to 20% which is far more than is necessary to cover losses, cover the cost of funds and make a decent profit. Risk has become a fob off excuse for gouging.

This enquiry has to ask why there is $14B on credit cards and force action by the banks to correct this inappropriate gouging that is undermining economic growth.

Pricing for Risk is not in line with APRA's capital requirements for risk

The banks are charging many business owners excessively higher rates based on the theory that they are higher risk, yet the banks are not maintaining additional capital for that same risk. A commercial unsecured loan at 10% interest and a commercial unsecured loan at 20% interest will both require the same amount of capital set aside by APRA. Yet the bank is charging 100% more interest on one loan over the other because it is supposedly a greater risk of default. If the banks are pricing for increased risk, then APRA should be ensuring more capital is set aside to cover that increased risk.

Recommendation:
It is highly recommended that APRA changes its Risk Weighting of Assets to take into account risk pricing. If the Bank is charging 20% on credit cards compared to 4.6% for a home loan then the bank should have to keep 400% more capital to cover the Credit Card loan as the banks are stating that the risk is 400% greater in their pricing model.

Benefits:

- This would stop the banks from abusing their market power in overcharging Credit Card holders on the excuse of risk and ensure that pricing risk and capital protection for risk is more aligned.
- This would rectify the economic problem where the RBA's lower interest rates are inflating a housing bubble, but is not being passed on to encourage investment by small businesses to drive employment and spending.

Media focus on mortgage rates is diverting focus on other borrowing rates

The media's front page headlines are around mortgage rates and in response politicians focus on mortgage rates despite it only effecting a third of voters. With the spot light on mortgages, it has become politically acceptable to make credit card holders and SME Businesses pay excessive rates to cover discounted rates on mortgages. It is important that this enquiry highlights this discriminatory practice to ensure that all users of funds pay a fair rate. Whilst SME businesses may have been fair game in the past, the threat to economic growth requires this situation to be rectified immediately.

SMEs would not be worse off with increased capital requirements on banks

In response to claims that increased capital would impact on lending and increase rates. Well my response to the major banks is frankly the SME sector who cannot get access to funding now could not be any further worse off and how much higher can rates go above the 15% to 20% that many are being charged. I would counter that SMEs would be better off if taxes could be reduced by no longer propping up banks with deposit guarantees.

Credit Reporting needs better scrutiny

A major hurdle for SME Businesses seeking finance is the poor quality of Credit Reporting in Australia. Whilst it is an important tool for banking there is little protection for the consumers and business owners to deal with a process that misleads on credit quality. Mistakes on credit reporting is financial defamation of character, yet banks and credit reporting agencies are not doing enough to ensure that the information is correct and presents the true financial position of the creditor. Creditor reporting agencies offload accountability to credit providers but the Government needs to put responsibility on the Credit Reporting Agencies to ensure veracity of credit information as they in turn can place the obligations on Banks to meet higher standards of quality in Credit Reporting. We require journalists to confirm sources, why are credit agencies entitled to lower standard of verification. We have a media council to review questionable reporting, but credit rating agencies are untouchable. Who is policing Credit Reporting organisations?

Question on quality of Credit Risk Assessment by major banks to justify lower capital

APRA allows the major banks to have a competitive edge to other ADIs in that they have lower capital requirements. This is supposedly because they have more sophisticated credit risk assessment processes than other ADIs. However APRA needs to challenge this. The new credit reporting changes came in last March. At this stage the major banks have not been loading new format data into the credit reporting system due to the poor quality of their internal credit records. All the major banks have major projects trying to improve the veracity of this information.

If the major banks have such a problem with the quality of credit information that they cannot meet the new reporting requirements, then how can they have the sophisticated systems to assess credit quality that justifies reduced capital requirements?

Furthermore, the credit assessment models are 20 years out of date. What worked in 1998 does not apply to today's market conditions, but that is exactly what the credit assessment models are doing. Not only is it difficult for many businesses to meet out of date requirements, but those businesses that can meet outdated criteria are not really any more secure because many of those assumptions no longer hold true. The GFC was largely the fault of a regulatory environment that did not challenge credit quality assessments and it is still a major problem today.

Superannuation has dried up working capital that the SME Sector requires access to

The superannuation investment model is creating an extraordinary systemic risk from investing in speculative instead of working capital that has sucked up funds needed for economic growth.

1. **Economic impact of moving funds from working capital to speculative**
   Very little of the $1.7T of superannuation funds is going into working capital that creates jobs, GDP and tax revenues. Increased share prices from speculative share trades does not convert into cash for the companies to use to build business. We have a scenario where less businesses are renting commercial property and those that are, are shrinking their footprint but the superannuation industry is building more commercial properties. Retail is in the doldrums but they are investing more in shopping centres. This is a recipe for disaster.

2. **Speculative pricing will collapse in response to liquidating for baby boomers retirement**
   The superannuation industry is largely investing in speculative investment such as shares and commercial property. Due to high demand from superannuation funds and limited supply of commercial properties and shares, this has artificially inflated prices. However with the ageing population and as the baby boomers retire, superannuation companies will all have to start liquidating assets at the same time reversing supply and demand and collapsing the value of retirement assets. This is driving the demand for super contributions to be increased to 15% to avoid the need to liquidate assets, but frankly this approach is nothing but a legislated Ponzi scheme of new entrants covering the failed investments of older investors and should not be a model entertained by governments in any form.

3. **Superannuation industry exposure to Banks a major problem**
   Around 30% of superannuation funds are invested in the major banks. Any action that is a detrimental to banks extraordinary profits is going to impact on retirees assets. A gross failure of

Government in managing this industry over the past two decades has created an extraordinary financial nightmare that increasing banking competition is going to hurt pensioners. A damned if we do and damned if we don't scenario. Politicians don't want to deal with this problem, but it is not going to go away and it is only going to get worse.

Recommendations

With great urgency Government has to legislate that Superannuation does more to diversify their portfolio and substantially reduce their exposure to speculatives such as commercial property and shares over the next 5 years so as to reduce the speculative market collapse as baby boomers retire. It is far better to have a controlled and limited collapse than an uncontrolled collapse.

With more of the $1.7T going back into working capital, this will boost growth and investment which will in the end lead back to better returns to the superannuation industry.

Bankruptcy laws in Australia increase lending risk

A sobering statistic is that in the USA 85% of businesses successfully come out of chapter 11, in Australia 5% come out of administration. The current administration laws increase the risk of defaults for banks. A large proportion of companies get into trouble from cash flow timing rather than structural problems and a revised bankruptcy legislation that allows breathing room for a company to get its house in order would reduce default risk for Australian lenders.

Recommendation

Whilst possibly outside the scope of this enquiry, I would ask that this enquiry make a recommendation to Government to consider changing bankruptcy laws to find better balance in business continuity and protecting creditors. This would radically change risk assessment and capital risk weightings for banks and it needs to be a recommendation from this enquiry for Government to review.

Discrimination of the flexible work force

Australia has the highest flexible work force in the OECD where self-employed, part time and casuals are now close to 50% of the work force. Most SME Business owners are classified as self-employed. However the banking sector has made unjustified assumptions on the risk of lending to the flexible work force and as such they are severely discriminated by the finance sector. It is ludicrous that a bank considers that someone self-employed on a 2 year contract is a higher risk than someone full time who is really on a one month contract. The flexible workforce is more capable of continual employment as they are wired to search for ongoing work all their life, whilst full time employees can struggle to get work if retrenched as they are unused to looking for employment. The flexible workforce often have multiple ongoing jobs where the loss of one job dents their income where a full time person loses all of their income when retrenched. This is again an example of credit assessment processes being out of date and out of touch with reality.

We cannot have an economic policy that is on one side pushing towards having an increasing proportion of the work force being a flexible work force and have a banking industry that does not cater for them, it is an unsustainable position where the banks are lending to a shrinking pool of what they deem as acceptable borrowers whilst a growing proportion of the work force is financially discriminated.

A lack of competition

There is a lack of competition and that has flowed on to a lack of innovation in the finance sector. Financial institutions in Australia are making margins not possible in the rest of the world and are not taking the risks that other institutions across the world are taking in lending. We have a captive market in Australia that has created monopoly conditions. On top of this, the major banks dominance means that tax payers have to protect "too big to fail" banks. The lack of competition is flowing on to having an economic impact where businesses are being forced under due to financial limitations and burdens.

In Summary

SME Business owners are looking for a change from the past excuses for inaction and want to see results now. We have politicians, regulators and banks who all refuse to take ownership and pass blame on to others. At the end of the day SME Business owners are still struggling to get access to funds for growth, which in turn impacts on employment and economic growth. It has been six years after the GFC and the economy is still in the doldrums, is it not time leaders connected the dots and recognise that we have created an environment that is inhibiting growth and start taking action to remove those road blocks. Is it not time we stopped finding reasons why we cannot lend to SME Businesses and find ways that we can lend and still meet risk management requirements. Is it not time we freed up the lazy capital invested in speculative markets and put it back into working capital that will grow business, grow jobs, grow tax revenues and grow the economy.

In the last 25 years businesses have had to adapt to changing globalised markets. In the last 25 years the workforce have had to adapt to less secure and less permanent employment. Yet we are faced with a banking sector and regulators applying metrics related to a past era. It is frustrating to negotiate with financial institutions who are trying to hold you to a yard stick from another era when your business model has been forced to change to adapt to new global markets. As a SME Business owner and as an Australian citizen, I strongly believe that we need to see drastic change in the finance sector to stop an inefficient and cumbersome sector from bringing down the Australian economy.

Research

The information in this report is from personal research gained from talking to small business owners, banking executives, regulators and the government to identify the issues and misconceptions. There is a problem where business owners do not understand the bankers and bankers don't understand SME Businesses. The purposed of this paper is to provide a different perspective to the problems that economic statistics tend to gloss over. Many of the stakeholders I have spoken to were not aware of many of these issues and hence it is important for this enquiry to understand how the current processes are impacting on SME Businesses and hence economic growth.