Small Business NSW Commissioner

Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
PARKES ACT 2600

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Dear Sir / Madam

Thank you for the opportunity to provide comment on the draft terms of reference for the Government's Financial System Inquiry.

My role as NSW Small Business Commissioner is to advocate on behalf of and support small business by:

- Providing dispute resolution services;
- Delivering quality business advice through the Small Biz Connect program; and
- Speaking up for small business within government.

Small businesses represent 96 per cent of all businesses in NSW. There are an estimated 680,000 small businesses which employ nearly 50 per cent of the State's workforce. Small businesses and start-ups thus have a vital role to play in the economy.

It is essential that the Inquiry addresses the relationship of the small business sector to the financial system. Of the estimated two million small businesses in Australia, 49 per cent have a business lending product other than a credit card. This is almost one million small businesses. If credit cards are included as a source of lending for small businesses, the proportion of small business who have a business lending product rises to 71 per cent, or 1.42 million small businesses.[1]

Moreover, small businesses and start-ups have specific needs, requirements, issues and risk profiles that are different from those of larger businesses. Theses include:

- The financial profile of small business as described in the Wallis Report suggest that generally small businesses are obtaining relatively small loans secured against personal assets, mainly from banks[2];
- Small businesses tend therefore to be more heavily reliant on debt finance than equity finance compared to larger businesses[3];
- They also generally face higher borrowing costs and more onerous loan conditions than larger businesses (and also households)[4];

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[1] Australian Bankers' Association and Council of Small Business Australia (COSBOA), *Small Businesses: Access to Finance Report, Year to March 2013*, p.11

[2] Report by the House of Representatives Standing Committee on Industry, Science and Technology *Finding a Balance: Towards Fair Trading in Australia*, May 1997, p.139

[3] Ibid, p.138

[4] Ibid.

- Small businesses are more likely to have their applications for funding rejected than larger businesses (this is particularly the case regarding venture capital funding for start-ups)[5];
- Small businesses often have difficulty understanding the terms and conditions of loan agreements they enter into[6]; and
- There has been evidence of financial institutions attempting to improve their loan portfolio risk profile by calling in loans during economic downturns. This has had an impact on small businesses, and was documented in the Senate Economic References Committee's *The Post-GFC Banking Sector* report of November 2012, which made a number of recommendations in respect of small business lending.[7]

There are a number of specific issues below relating to small business that I believe the Inquiry should address in the finalised terms of reference.

Difficulties in accessing finance

Access to finance remains a significant issue for start-ups and small businesses. According to Australian Bureau of Statistics data, access to finance is the number one barrier to innovation for Australian businesses and the third largest barrier to general business activity.[8]

Research carried out by Deloitte Access Economics estimates that about 10 percent of Australian SMEs, or around 200,000 businesses, have difficulties accessing finance.[9]

Furthermore, NSW Business Chamber survey results show that 30 percent of businesses surveyed perceived that they had missed an opportunity in the two years to July 2012 due to a lack of credit, and 50 percent of those who had loans applications rejected reported that it significantly constrained their growth.[10]

The NSW Business Chamber survey results also indicated that 20 percent of businesses who had loans rejected had to lay off staff or saw their chances of bankruptcy significantly increase.[11]

Given the importance of start-ups and small businesses to the overall economy, difficulty in accessing finance thus has the potential to significantly curtail economic growth, investment and employment.

Additionally, unlike larger businesses, many small business owners borrow against the value of their homes in order to get their business off the ground. An estimated 49,644 small businesses use their residential mortgage to fund their small business.[12]

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[5] Reserve Bank of Australia, *Small Business Finance Roundtable, 22 May 2012*, p.16

[6] Report by the House of Representatives Standing Committee on Industry, Science and Technology *Finding a Balance: Towards Fair Trading in Australia*, May 1997, p.140

[7] Ibid, p.143

[8] ABS Catalogue 8167.0 - *Selected Characteristics of Australian Business, 2011-12*

[9] Deloitte Access Economics and Professor Marc Cowling for the NSW Business Chamber, *Small Business Access to Finance*, 2013, p.7

[10] Ibid, p.9

[11] Ibid.

[12] Australian Bankers' Association and Council of Small Business Australia, *Small Businesses: Access to Finance Report Year to March 2013*, p.16

With rates of home ownership lower for Gen Y, this option may be less viable in future years, further constraining access to finance by start-ups and small businesses.

It is therefore essential that the Inquiry address access to finance for small businesses.

One cohort of small businesses who have difficulty in accessing finance are businesses seeking investment in "equity gaps" where it is difficult to secure finance from traditional risk capital providers. Another is businesses that do not fit the high-risk, high-return profile served by many traditional risk finance providers.

These businesses may not have the potential to deliver the exceptional returns that venture capitalists seek, however they may also be less risky and still provide significant value to the economy.

I have also spoken to a number of small businesses who have found it difficult to source funding to make capital investments in energy saving measures. This is another area that might be investigated, given that these investments will improve both business profitability and environmental outcomes.

Potential additional sources of finance for SMEs and start-ups

<u>Crowdfunding</u>
In this context, equity crowdfunding has the potential to be a valuable complementary source of capital to the traditional providers in the market, offering finance to businesses currently struggling to source investment. To this end, I have recently made a submission to the Corporations and Markets Advisory Committee (CAMAC) review of the regulatory arrangements for crowdsourced equity funding in Australia.

<u>Peer-to-peer lending</u>
I would advocate that similar consideration also be given to the regime for peer-to-peer finance in Australia, particularly with a view to providing greater regulatory certainty.

While similar to crowdfunding, peer-to-peer lending is distinct. The term peer-to-peer lending has its origins in the facilitation of unsecured personal lending between individuals (i.e. loans are made to an individual rather than a company and borrowers do not provide collateral as a protection to the lender against default) via online sites such as Zopa, Lending Club and Prosper.[13]

There has been explosive growth in peer-to-peer personal lending across the world in the last decade, driven by the many-to-many communication paradigm of the internet, and various reports have looked at several aspects of this model such as the borrowers and lenders characteristics, motivations and strategies.[14]

However, the development of peer-to-peer lending to business in Australia is considerably behind that of jurisdictions such as the US and the UK. It is essential that Australia is not left behind in this respect. Nesta has estimated that peer-to-peer lending has the potential for £12.3 billion p.a. of business lending in the UK, mainly to SMEs

[13] Yannis Pierrakis and Liam Collins for Nesta, *Banking on Each Other Peer-to-peer Lending to Business: Evidence from Funding Circle*, April 2013, p.11
[14] Ibid.

(traditional bank lending to SMEs is approximately £36 billion p.a.).[15] Andy Haldane, Head of Policy at the Bank of England, said in a speech in New York in March 2012 that "small peer-to-peer lenders ...could in time replace high street banks".[16]

The UK Government announced on 7th December 2012 that a regulatory framework will be established for peer-to-peer lending. To this end, the UK Treasury conducted consultations in 2013. Responsibility will be given to the new regulatory body, the Financial Conduct Authority (FCA) during 2014.

Additionally, there are other sources of finance for small businesses and start-ups that should be explored.

Facilitating SME access to public corporate bond markets

The Inquiry should investigate the possibility of facilitating SME access to public corporate bond markets. This might include a feasibility study into the creation of an aggregation agency to lend directly to SMEs and/or pool SME loans to facilitate SME access to public corporate bond markets. This was one of the recommendations of the 2012 Breedon Report on the state of lending to SMEs in the UK.[17]

In its response to the Breedon Report, the UK government supported the undertaking of this feasibility study and is now in receipt of it.

Such an agency would facilitate the provision of long term investment capital to those businesses which cannot currently access the capital markets and which therefore are almost entirely reliant on banks for their financing. It might operate in a variety of ways to allow it to tap as many different sources of funds as possible. It could operate by buying, funding, guaranteeing or providing hedging of or to, either individual loans or aggregate portfolios of loans.[18]

This would help ensure that high growth SMEs and mid-cap businesses have more choice in access to longer-term investment capital than is currently available. While these businesses can often satisfy their working capital requirements through overdrafts, credit cards, trade or asset finance, their longer term 'patient' finance options (five years plus) are scarcer.[19]

Facilitation of investment by superannuation funds

Another option is the facilitation of investment by superannuation funds in venture capital and small business generally. The Australian superannuation industry's share of total financial institution assets in Australia is second only to that of the banks.[20] Moreover, the Australian superannuation industry's total funds under management is projected to grow rapidly to $7.6 trillion by 2033 (the figure for 30 June 2013 is $1.6 trillion), or

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[15] Ibid, p.3

[16] Paper by Robleh D Ali, Andrew G Haldane and Paul Nahai-Williamson, presented at the Securities Industry and Financial Markets Association (SIFMA), Building a Global Legal Entity Identifier Framework, Symposium, New York, 14 March 2012

[17] Association for Financial Markets in Europe (AFME), *An Agency for Business Lending – "ABLe,"* October 2012, p.1

[18] Ibid, p.4

[19] Ibid, p.1

[20] KPMG, *Superannuation Trends and Implications, November 2011*, p.2

approximately 180 percent of GDP (the figure as at 30 June 2013 is less than 100 percent).[21]

Given this rapid increase, superannuation funds managers will increasingly be looking for investment opportunities in addition to domestic equities, which currently comprise a significant proportion of portfolios. Small businesses and start-ups are capable of providing additional opportunities for investment which will at the same time grow domestic investment, employment and economic growth, as opposed to other asset classes such as foreign REITs.

Bank fees

Small businesses in Australia are also paying disproportionately high bank fees. This is another issue that the Inquiry should investigate. According to the Reserve Bank of Australia's *Payment System Board Annual Report 2013*, small business operators are paying up to 10 times more in bank fees than big business. Small businesses are paying as much as 2 percent in interchange fees for transactions, compared to the 0.2 percent that large businesses pay.

Large businesses are generally able to negotiate lower 'strategic rates' because of their higher transactions volumes.

While some retailers currently only accept credit cards for payments over a certain amount, as consumers use less and less cash, the pressure to take cards will increase. This will in turn cost small businesses more, putting them at a further disadvantage.

The Inquiry should therefore investigate the issue of bank fees charged to small businesses and ways to reduce these imposts on small businesses.

Recommendation

The terms of reference for the Inquiry should include a section specifically addressing issues relating to start-ups and small businesses. For example:

In relation to the small business and start-ups, the Inquiry will:

- Assess current levels of access to finance for small businesses and start-ups in comparison to earlier periods; in comparison to larger businesses and in comparison to other jurisdictions;
- Identify impediments to accessing finance by small business and start-ups and their likely causes, including market failures and regulatory settings;
- Consider how small business and start-up access to finance is likely to evolve in the years ahead; and
- Explore cost-effective measures to improve access to capital for small businesses and start-ups, including per-to-peer finance, facilitating SME access to public corporate bond markets and facilitation of investment by superannuation funds;
- Consider the levels of bank fees faced by small businesses and start-ups in comparison to earlier periods; in comparison to larger businesses and in comparison to other jurisdictions; and whether and how this issue should be addressed.

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[21] Deloitte, *Dynamics of the Australian Superannuation System, the Next 20 Years: 2013-2033*, p.1

I do not feel that the current terms of reference (for example section 1.3) are sufficient in this regard.

Should you wish to discuss any of the issues raised in this submission please contact Adam Spivakovsky, A/Senior Advisor, Advocacy on (02) 8222 4833.

Yours sincerely

Yasmin King
NSW Small Business Commissioner
5 December 2013