

Financial System Inquiry
GPO Box 89
Sydney
NSW 2001

By email: fsi@fsi.gov.au

Dear Sir or Madam,

Financial System Inquiry – Interim Report

Thank you for giving the Office of the NSW Small Business Commissioner the opportunity to make a second round submission to provide feedback on the observations and potential policy options set out in the Financial System Inquiry's Interim Report released 15 July 2014 (interim report).

The Office of the NSW Small Business Commissioner was established in mid-2011 to support small businesses throughout NSW. Our role is to:

- provide dispute resolution services;
- speak up for small business within government; and
- deliver quality business advice through Small Biz Connect.

We are focused on improving the operating environment for the approximate 680,000 small businesses within NSW, which employ around 1.5 million people, and play a vital role in this state's economy.

We support looking at the financial system and the principles that should guide its development. We are particularly interested in the inquiry's findings pertaining to small business interaction with the financial system – which will be the focus of our comments herein.

Of the approximately 2 million small businesses in Australia, almost one million, have a business lending product other than a credit card. If credit cards are included as a source of lending, the proportion with a lending product totals about 1.42 million small businesses.¹

Card-not-present fraud

An issue not specifically discussed in the interim report that we think merits attention in the final report is card-not-present fraud. This crime occurs when valid card details are stolen and later used to make fraudulent payments online, by telephone or by mail order.²

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

² Australian Payments Clearing Association 2014, *Australian Payments Fraud Details and Data*

In calendar year 2013, card-not-present fraud in Australia totalled \$219.7 million – an increase of 20% on the prior year total.³ In 2013 card-not-present fraud accounted for 72% of total Australian card fraud.⁴

If a merchant accepts a credit card payment and the card is not physically present, the liability for loss falls to the merchant, rather than to the card issuing financial institution. The full value of a card-not-present purchase can be 'charged back' to the merchant if a purchase is made fraudulently.⁵

We see moral hazard arising from this arrangement. While financial institutions are the appropriate parties to develop initiatives to reduce card-not-present fraud, they may not be sufficiently incentivised to do so, because they don't bear the consequences of the fraud or accept any responsibility for its occurrence.

Because certain merchant sales may tend to command only low margins, even a small number of 'charge backs' can have a significant impact, particularly on small businesses.

The payments industry has implemented measures to help prevent card-not-present fraud, such as the 3 or 4 digit code written on the card itself, and online authentication tools, 'American Express SafeKey', 'MasterCard SecureCode' or 'Verified by Visa'.⁶

Commending to merchants fraud prevention measures that they should take is a common approach of Australian banks. Effective measures include merchants remitting small deposits to a suspect buyer's account, and then later contacting the buyer to verify the amounts deposited. Such measures add friction to the sales process, workload to merchants, and may tend to frustrate customers.

Buying stolen credit cards online is relatively simple. 'Carder' web sites enable granular search according to type of card, bank name and country. Users can also select additional personal information about card holders including address, email address, phone number, date of birth etc. Such web sites can offer fast purchases, instant validity checking to ensure a stolen card is still valid, and instant refund if it isn't.⁷

In 2010, credit card information was the most commonly sold item in the underground economy, accounting for 22% of items for sale.⁸ This was up from 19% in 2009.⁹ Prices for stolen card data ranged from to US\$0.07 to US\$100.¹⁰

Payment gateway providers enable merchants to accept online payments. Most generally perform automated assessments that flag to merchants suspicious transactions. However, we are advised that the information available to them in Australia is limited, compared to the USA, where data sharing by financial institutions enables payment gateway providers to query a greater number of characteristics and better assess transaction risk almost instantaneously.

³ Australian Payments Clearing Association 2014, *Australian Payments Fraud Details and Data*

⁴ Ibid

⁵ Accertify Whitepaper 2007, *Card Not Present Fraud*

⁶ Australian Payments Clearing Association 2014, *Australian Payments Fraud Details and Data*

⁷ Wagenseil, P., Tom's Guide US 2014, *How to Buy Stolen Credit Cards from the 'Amazon of Cybercrime'*

⁸ Australian Crime Commission, *Crime Profile Series — Card Fraud*

⁹ Ibid

¹⁰ Ibid

We understand that improved data sharing through use of existing technology between Australian banks and payment gateway providers could eliminate a significant proportion of card-not-present fraud, allowing merchants to spend less time on fraud mitigation activities. We encourage the inquiry consider this matter, and make recommendations in the final report with respect to industry or Government-led initiatives that may assist.

Changes in margins above cash rate for different loan types

We observe from the RBA data contained in chart 2.2 of the interim report that spreads above the cash rate for (residentially secured) small business loans, were much closer to those for housing loans, and large business loans in 2007-08 than at 2013-14. The most recent data point seems to indicate an approximate difference of 125 basis points between (residentially secured) small business loans and large business loans, placing small businesses at a competitive disadvantage.

The interim report suggests the increase in SME lending spreads reflects a re-evaluation of risk in that lending category and a general increase in the price of risk, and says it is not clear if any of the increase in spreads was due to reduced competition.

We note the contraction since 2008 of lenders in the Australian market via mergers and acquisitions, including St George Bank, Bank of Melbourne, Adelaide Bank, Bankwest and Colonial State Bank, and the withdrawal of foreign banks including ABN Amro and Societe Generale. Additionally, a number of finance companies have been absorbed by their parent bank or acquired by a third party, creating more reliance on remaining lenders.¹¹

We encourage the inquiry to examine and discuss in its final report the extent to which risk in (residentially secured) small business loans *actually* changed between 2007-08 and 2013-14 and how risk in that sector compares to housing loans, and large business loans in the same period.

Comprehensive credit reporting

Comprehensive credit reporting (CCR) is a voluntary program introduced in March 2014 to enable lenders to share *consumer* repayment histories. Under the prior credit reporting regime, lenders could share only negative credit events, such as a default. The shift from a negative to a positive credit reporting system might promote competition by enabling lenders to more accurately assess the credit worthiness of borrowers, and to compete for customers by offering risk-based pricing.¹²

The option to extend credit reporting to SMEs is raised in the interim report as a policy option for consultation that may have the potential to improve SME credit risk assessments and improve SME access to funding.

The interim report discusses challenges with this, including credit providers' reluctance to participate, as well as privacy challenges. It also refers to submissions that propose making CCR mandatory.

¹¹ Commercial Asset Finance Brokers Association of Australia Limited 2014, *First round submission to the Financial System Inquiry*.

¹² The Financial System Inquiry 2014 (Murray) *Interim Report*, p.2-18

We support initiatives that would improve access to funding for small businesses, but would value evidence of the costs, benefits and probable effectiveness of this prior to expressing support for *mandatorily* extended credit reporting for SMEs.

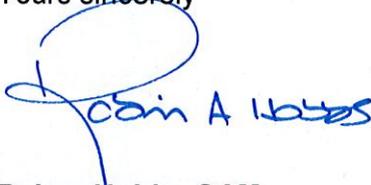
Financing conditions for small and medium enterprises – access

We note that the majority of small business applicants have been successful in getting their loan applications approved, with debt finance obtained in around 87% of cases during 2011-12.¹³

This figure naturally doesn't capture potential applicants who declined to make a formal application for finance. Since where an applicant is rejected by a lender, it counts against them when they next apply¹⁴, we expect borrower caution is commonplace, although it is difficult to identify data that would quantify this effect. Perhaps the inquiry can further explore this in the final report.

We appreciate the opportunity to comment on the financial system inquiry's interim report. Should you wish to discuss any of the issues raised in this submission, please contact Murray Johnston, Principal Advisor, Advocacy on (02) 8222 4842.

Yours sincerely



Robyn Hobbs OAM
NSW Small Business Commissioner

2 September 2014



¹³ 8167.0 - Selected Characteristics of Australian Business, Business Finance 2011-12 (Released 2013)

¹⁴ NSW Business Chamber 2013, *Small Business Access to Finance*