CHAPTER 36: SECTORAL ASSISTANCE: GENERAL APPROACH

A. BACKGROUND

36.1 Governments pursue a wide range of policies designed to influence the cost and availability of finance to particular groups or activities.

36.2 Among the sectors or purposes for which special provision has been sought in submisssions to the Committee are:

- certain public authorities
- housing
- small business
- innovation
- structural adjustment
- rural production
- exports
- low income groups
- certain regional areas
- the retired
- long-term resource development

36.3 This chapter outlines the general principles which have guided the Committee in relation to sectoral assistance. Later chapters focus on the financial needs of particular groups which were the subject of submissions to the Inquiry. Some issues relevant to other groups are covered in earlier chapters.[1]

36.4 **Arguments** for sectoral assistance essentially rest on considerations of:

- *Market imperfections* — i.e. where the market is failing to respond appropriately to demand and supply signals and to exploit commercially profitable opportunities. These imperfections may be due to government regulation, information gaps, lack of competition etc.
- *Economic externalities* — i.e. where the market is working efficiently in a technical sense but is failing to reward adequately activities which yield significant benefits to other sections of the community over and above their private returns.
- *Distributional inequities.*

36.5 The Committee has not sought to assess the appropriate level of assistance

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1 See, for example, Chapters 11 (the retired), 12 (public authorities) and 35 (long-term resource development).

to particular groups — where these are based on **economic externalities** or **distributional inequities**. The judgments involved extend well beyond questions of economic efficiency and are outside the Committee's terms of reference. The Committee has instead focused solely on the **methods** of assistance and their implications for the financial system.

36.6 On the other hand, the Committee has examined the validity of arguments for sectoral assistance based on **market imperfections** originating within the financial system. In various chapters it has tried to identify market gaps and where necessary it has recommended appropriate remedies, e.g. action to stimulate greater competition or removal of government regulations impeding the flow of funds to particular groups or sectors.

36.7 If such remedies are not practicable or acceptable to governments, they may wish to 'offset' the effects of the market imperfection by assisting particular sectors or groups they believe to be adversely affected. Such a course of action carries with it certain risks: no form of government intervention is costless and the distorting effects of government intervention may outweigh the benefits derived from a preferred distribution of funds. Nonetheless, if governments do choose this course, the question again arises as to the most appropriate method of providing the desired assistance with minimal costs for the financial system.

36.8 In summary, whether the rationale of sectoral assistance is based on economic externalities, distributional inequities or market imperfections, governments should only intervene where the net benefits to be derived are clearly positive; in this regard, the key issue for the Committee is the relative cost-effectiveness of alternative methods of sectoral assistance — and especially those methods which involve intervention in the financial system.

36.9 A paper prepared for the Committee[2] summarises current economic thinking on alternative methods of sectoral assistance.

36.10 As explained above, if the problem arises from market imperfections, these must be dealt with first. Beyond this, a wide range of corrective measures are available to the authorities. These can be ranked in a general hierarchy of policy options — all equally effective in dealing with particular problems but those with lower down the hierarchy generating greater 'by-product distortions' (i.e. having more adverse effects on other sectors or groups in the community). Thus at each step down the hierarchy the net welfare benefits are correspondingly lower.

36.11 In terms of this hierarchy, the Committee's order of preference, from an efficiency viewpoint, is:

(i) an untied grant directed at the group in question;

(ii) a specific fiscal subsidy tied to the provision of credit, but delivered directly to the borrower (e.g. by way of direct cash assistance to eligible borrowers) or transmitted through established commercial intermediaries; such 'credit-specific' assistance is inferior to (i) as it encourages over-use of credit and may distort savings patterns;

(iii) as in (ii), but with the assistance transmitted exclusively through a government-owned intermediary; this creates an additional distortion by reducing the competitive neutrality of the system; and

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2 'The Economics of Sectoral Assistance: A Survey of the Literature', R. Albon and A. Cheok, in AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

(iv) financial regulation, e.g. bank interest rate or qualitative lending controls; this creates further distortions such as operational inefficiencies, less-than-optimum funds allocation (e.g. under-representation of bank deposits in the public's savings portfolio), lack of adequate government accountability, and arbitrary distributional effects.

36.12 The Committee believes that financial regulation (as a method of sectoral assistance) is seldom justified. On the other hand, a credit-specific grant may well rank **first**, in some circumstances, in order of preference. This would be so if there is an imperfection in the credit market and it cannot be dealt with at its source (e.g. by stimulating competition); or if the externality problem arises out of ineffective access to the credit market. For example, if the government wished to increase the availability of long-term finance to farmers it might make sense to pursue this objective by transmittng specific subsidies through commercial intermediaries normally catering for this group.

36.13 All too often, however, governments have sought solutions through the creation of government-owned intermediaries or financial regulation when they could have achieved their objectives at least as effectively through either a cash grant financed out of a neutral tax arrangement, or through the subsidisation of specific loans made through established intermediaries. In this way, government policies designed to relieve an apparent distributional or market problem may, in their application, themselves create new distributional inequities or structural market deficiencies.

B. SECTORAL ASSISTANCE THROUGH FINANCIAL REGULATION

36.14 Although economic stabilisation and prudential considerations have influenced the differential regulation of various financial intermediary groups, the apparent rationale for at least some of the regulation has been sectoral assistance.

36.15 The techniques of such intervention have tended to range over:

- interest rate ceilings, particularly on bank deposits and loans and on some of the operations of building societies;
- prescribed asset ratios designed to favour government securities or housing; and
- qualitative lending controls.

36.16 The Committee would like to have presented a detailed account of the **value** of sectoral assistance effected through financial regulation and to identify the groups receiving and contributing assistance. However, that was not possible. The **value** of assistance transferred through the financial system is a function of quantities and prices actually charged relative to likely 'free market' outcomes in the absence of that intervention. The latter cannot be precisely ascertained. Matters are further complicated because the groups receiving assistance (e.g. ultimate borrowers from savings banks) often overlap with those in effect being 'conscripted' into providing the assistance (e.g. depositors with these intermediaries).

36.17 There are real doubts about the **effectiveness** of financial regulation in actually delivering the assistance which policy has deemed desirable. While a substantial redistribution of income and wealth is effected by financial regulation,

it is not clear that the benefits of low interest credit are always received by those borrowers the policy is intended to assist. This is because:

- Regulations commonly induce regulated intermediaries to resort to non-price credit rationing practices such as excessive collateral requirements and somewhat arbitrary risk screening. Those who qualify (and hence receive loans at regulated rates) are often not those most needing assistance.
- Interest rate and other selective credit controls often have the perverse effect of reducing the funds available from regulated institutions, by inhibiting their ability to compete for funds.

36.18 It may well be, therefore, that lower income and other disadvantaged groups are unintentionally placed at a greater disadvantage under a system of selective credit regulation. In some cases these groups have to resort to higher cost loans from other 'free market' sources or are denied finance altogether.

36.19 There is also the question of who really pays the bill for sectoral assistance provided through credit regulation. Credit provided on concessional terms generally means that the suppliers of the loanable funds, e.g. bank and building society depositors, receive a lower rate of interest on their deposits.

36.20 As the assistance given to borrowers is being **voluntarily** financed by those continuing to hold low-yielding deposits and investments with regulated institutions, it is sometimes argued that assistance delivered through the financial system is 'costless'. This view is, in the opinion of the Committee, quite erroneous. In a better informed and less regulated financial system, savers would be generally less willing to accept sub-market interest rates. The Committee finds support in this judgment in the initial marketing success of Australian Savings Bonds and more recently in the rapid growth of cash management trusts.

36.21 It is true that the costs of regulation mentioned above are essentially **distributional** in character: while some people in the community are worse off, others are clearly better off. However, as suggested earlier, the redistributive effects of regulation are much more arbitrary, and generally much less equitable, than if the sectoral assistance had been provided through the taxation system. Moreover, there are efficiency costs associated with financial regulation which tend to make the community as a whole worse off,[3] for example:

- regulation of the interest rates and portfolios of financial intermediaries impinges on the operational flexibility of the financial system and hence on its ability to meet the changing needs of borrowers and lenders;
- a tendency is created for financing activity to be shifted from the regulated group to institutions beyond the ambit of control, in some cases into relatively less efficient financing channels;
- the differential regulation of various financial intermediary groups results in a fragmentation of financial markets; the resulting segmentation of financial markets impedes the efficient flow of funds;
- financial regulation is also subject to the same criticism as other credit-specific forms of assistance — i.e. it encourages over-use of credit (see paragraph 36.33).

36.22 In summary, financial regulation often creates new distortions in the process of trying to correct for existing distortions.

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3 The costs are more fully discussed in Chapter 4 and its Appendix.

36.23 The Committee does not, of course, question the importance of the social or economic objectives underlying financial regulation. The important issue is whether the same objectives can be pursued more cost-effectively through alternative channels.

36.24 In assessing the costs and benefits one should allow for the possibility that an unconstrained market for credit would have a greater capacity and incentive to produce structural and technical innovations. For instance, there is considerable scope for such innovations in financial contracts that would make them more flexible and helpful in meeting the reasonable needs of prospective borrowers.[4] If borrowers were to be served more effectively this may reduce the need for some forms of sectoral assistance.

C. SECTORAL ASSISTANCE THROUGH FISCAL MEASURES

(a) Fiscal Assistance v. Financial Regulation

36.25 It is the Committee's assessment that sectoral assistance is usually best provided through fiscal subsidies; preferably in the form of budget outlays tailored to the needs of the target group, and financed through a 'neutral' tax. A tax concession closely approximates a direct grant in most instances.

36.26 Direct fiscal subsidies are strongly favoured in preference to financial regulation for reasons of efficiency, effectiveness, equity and accountability:

- *Efficiency* — Fiscal intervention can be designed to interfere less with resource allocation decisions since competitive market forces still have full scope to operate within the allowed price/cost framework; the 'by-product' distortions of financial regulation are less likely to occur.
- *Effectiveness* — Fiscal intervention is addressed more directly to the group (sector or activity) to be assisted; it is therefore less likely to have a perverse impact on the target group.
- *Equity* — Where assistance is given, the cost to others in the community should be borne equitably. Distribution of the cost through the general taxation system is clearly a fairer means of apportionment than recourse to financial regulation which requires those lending to regulated institutions to shoulder most of the burden.
- *Accountability* — Government intervention should, as far as possible, proceed openly. Tax and expenditure decisions taken in the context of the Budget meet this criterion of open accountability; intervention through financial regulation often does not. Indeed, as previously mentioned, assistance through financial regulation is often incorrectly perceived to be costless.

(b) Forms of Fiscal Assistance

36.27 The Committee first notes certain distinctions between 'general' (untied) and 'tied' fiscal assistance.

36.28 In its 'untied' form, fiscal assistance is a **general** supplement to income. This could be by way of general cash grants and general tax concessions.

4 It has been put to the Committee that if the major housing lenders were operating in a less regulated market their need to ration funds would be less and that, indeed, competition would result in a wider range of housing loan packages, some of which could well be better suited to the low income earners seeking home ownership for the first time.

36.29 In its 'tied' form, fiscal assistance is linked to particular financings and specific expenditures; it could be categorised as follows:

(i) *Credit-specific assistance*, designed to benefit particular eligible borrowers (e.g. low income groups); the assistance can take the form of:
- direct cash grants to ultimate borrowers;
- tax deductions to individuals in respect of interest payments on loans;
- annual budget allocations to financial institutions to enable them to make loans on concessional terms to eligible borrowers; and
- capital (or long-term debt) allocations to institutions for similar purposes.

(ii) *Goods-specific assistance*, for example home savings grants, bounties paid for the use of superphosphate, rebates of medical expenses, investment allowances and grants for research.

(iii) *Combined credit-specific and goods-specific assistance*, such as cash grants to the Australian Wheat Board to defray the additional costs of marketing finance obtained on the open market, or tax deductions in respect of interest payments on housing loans.

36.30 The Committee's main interest is in the first and third categories because of their particular impacts on the financial system.

(c) General v. Credit-specific/Goods-specific Fiscal Assistance

36.31 Where the purpose of the fiscal measure is to assist the needy (relieve hardship), there is an economic case for providing it in a general 'untied' form — i.e. in the form of cash grants and general tax concessions, rather than tied to credit (or for that matter to particular expenditures).

36.32 General (untied) assistance provides recipients with an increased **general** capacity to spend rather than an increased provision of specified goods and services; it thus enables them to organise their expenditures in the order of **their** personal preference. **It assumes that they know more about and shall act in accordance with their greatest needs.** The increase in community welfare from a given grant is thus said to be maximised at least in economic terms. The efficacy of this general approach depends importantly on the presumption that the assistance given will be put to good use, a presumption which may not always be warranted.

36.33 By contrast, intervention through the financial system subsidises a particular factor of production, namely credit, and only indirectly the final product or activity to be assisted. Apart from the tendency to encourage credit-intensive expenditures, borrowed funds are fungible and because the activities of most borrowers extend beyond the area to be assisted there is a degree of imprecision about the input of assistance and the output of preferred goods and services. Credit subsidisation runs the risk of distorting resource allocation decisions.[5]

36.34 Credit-specific subsidies by way of concessional loans and other forms of loan assistance may also impair the overall efficiency of financial intermediation, particularly if selective channels of transmission, such as government financial institutions (GFIs), are used.

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5 For example, it may have the effect of encouraging a small business to employ more capital relative to labour than if a general cash grant had been offered instead.

36.35 The Committee, however, recognises that:

- assistance tied to credit may be appropriate where it is used to correct for particular externalities or imperfections endogenous to credit markets;
- governments may favour the subsidising of particular expenditures (rather than general cash payments and tax concessions) where they have specific objectives in mind for the assistance; segments of the taxpaying public may indeed prefer that assistance be tied to particular expenditures.

(d) Transmission of Credit-specific Assistance

36.36 Where a credit-specific form of fiscal subsidy is used, questions arise as to how such a subsidy should be transmitted and administered, and what role, if any, GFIs should play in the process.

36.37 Some government intervention in the financial system is effected through and arises from its ownership of particular financial institutions — including the Commonwealth Development Bank, the Australian Industry Development Corporation, the Housing Loans Insurance Corporation, and the Export Finance and Insurance Corporation.

36.38 The Committee has argued elswhere (see Chapter 26) that **predominantly commercial government-owned financial institutions** do not have a widespread role to play in a competitive, deregulated financial system. It has also argued that if such institutions were to continue to exist under government ownership a number of disciplines would need to be observed.

36.39 Concern, in this chapter, is with the role of GFIs **as instruments or vehicles of sectoral assistance.** Given that on efficiency or other grounds governments will at times wish to convey assistance to particular groups in the form of a credit-specific subsidy (in preference to a general cash grant or tax concession), the question is whether credit-specific subsidies are best transmitted through GFIs or government departments, in preference to established private intermediaries (acting as agents for government). The question has added point when the issue is whether or not to establish a new GFI for the purpose.

36.40 Formal agency arrangements with established commercial operators presently exist. One example is the use of terminating building societies to process and approve applications for concessional home loans, in accordance with criteria laid down by government. The 'managing agents' also arrange the collection of repayments and provide associated loan management services.

36.41 There can be a saving in administrative costs in such arrangements with private sector intermediaries, particularly where the scheme involves areas of the economy in which government representation is limited and where, in addition:

- the eligibility criteria are specific, unambiguous and non-discretionary;
- special appraisal skills of a non-commercial character are not required; and
- there is little need for extensive audit safeguards.

36.42 These conditions may not exist at all times; for example eligibility criteria can be quite complex and in marginal cases some 'official' discretion may be required.

36.43 While the use of private intermediaries to transmit credit-specific subsidies may not **always** be appropriate, the Committee nonetheless considers that:

- they offer a satisfactory channel of assistance in many instances; and

- where they do not, the Government may be able to use established departmental facilities to administer the subsidy at least as efficiently as through a separately incorporated government-owned intermediary.[6]

36.44 The degree of involvement of the authorities relative to private sector organisations will depend importantly on the group to be assisted, the nature of the assistance and the term for which it is to be provided. The Committee believes however that in most, if not all, cases suitable arrangements would not depend crucially on the existence of a GFI.

36.45 Where the commercial infrastructure is used to disburse subsidies, it would be desirable in the interests of competitive neutrality for all intermediaries ordinarily involved to have equal opportunity to participate whenever possible. While administrative convenience may make it desirable to limit participation, inflexible restrictions may run counter to longer run efficiency and competition. One possible approach would be to open the agency arrangements for competitive tendering.

36.46 An alternative approach would be for the government to channel funds through a central intermediary representing the appropriate commercial institutions, as presently applies in the case of concessional lending through the Primary Industry Bank of Australia.

D. CONCLUSIONS AND POLICY GUIDELINES

36.47 In its discussion, the Committee recognised a hierarchy of policies to deal with particular types of problems (market imperfections, externalities, or distributional inequities); in the case of almost every problem there would seem to be a solution superior to direct intervention in the affairs of commercial financial intermediaries.

36.48 In the light of its discussion, the Committee puts forward the following guidelines for government consideration:

- **Where the need for sectoral assistance arises from market failure it should be met in the first instance, where possible, by removal of the cause (e.g. barriers to entry, restrictive trade practices, inappropriate government regulation).**
- **Where sectoral assistance is to be given because of perceived externalities or other social reasons it should be effected, as far as practicable, directly through the Budget process — and not indirectly through intervention in the financial system, except where the source of the problem lies in the system itself.**
- **Generally, disadvantaged persons should be assisted by general welfare measures. However, where the social objectives are specific — e.g. the promotion of home ownership — a case for a tied credit-specific subsidy can be developed even though strict economic logic would suggest that an overall improvement in welfare could be obtained more efficiently by a program of gereral assistance.**

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6 It is recognised that some subsidy programs straddle the responsibilities of several departments but this should not present insurmountable administrative problems.

- Where credit-specific techniques are used, the Government should seek *to disburse sectoral assistance* by measures other than allocating non-commercial functions to government-owned financial institutions. The assistance should preferably be disbursed directly to the borrower. Another alternative approach would be to *subsidise the performance* of specified non-commercial functions by established financial institutions, both private and government-owned.
- Regulation of financial intermediaries and processes is the least desirable (most distortive) form of sectoral assistance and in almost all cases should be avoided.

CHAPTER 37: HOUSING FINANCE AND SECONDARY MORTGAGE MARKETS

I HOUSING FINANCE

A. BACKGROUND

37.1 The main institutional lenders for housing are the savings banks and permanent building societies. Detailed information on their importance relative to other sources of housing finance is provided in Table 37.1.

37.2 Governments have traditionally shown special concern for the availability and cost of housing finance. This has been reflected in:

- prescription of the assets savings banks and building societies are permitted to hold;
- the regulation of and exercise of moral suasion over the borrowing and/or lending rates of interest of these institutions;
- specific action at times to insulate housing finance from general monetary policies of restraint; and
- fiscal subsidies for home buyers (e.g. home savings grants) tied to savings with housing finance institutions, which encourage a larger flow of deposits to these institutions.

37.3 As well, the non-taxation of capital gains (except of course where houses are acquired with a view to resale at a profit) has encouraged both home ownership and investment in housing generally.

TABLE 37.1: HOUSING MORTGAGE DEBT OUTSTANDING

	1970 $m	%	*1975* $m	%	*1980* $m	%
Major trading banks	297	6.0	614	5.2	1 060	4.2
Savings banks[a]	1 898	38.5	4 502	37.9	10 640	42.6
Finance companies[b]	750[c]	15.2	2 242	18.9	2 768	11.1
Credit unions	n.a.	—	n.a.	—	309	1.2
Permanent building societies[b]	929	18.9	3 128	26.3	8 286	33.2
Terminating building societies	628	12.8	894	7.5	1 432	5.7
Life offices	422	8.6	491	4.1	488	2.0
Total	4 924	100.0	11 871	100.0	24 983	100.0

(a) Does not include loans to building societies.
(b) Includes commercial loans.
(c) Estimate, provided by Australian Finance Conference.

Source: Australian Bureau of Statistics, Catalogue Nos 5.1, 5.2, 5605.0, 5.5, 5632.0, 5633.0, 5616.0, 5618.0, 5621.0

37.4 In these various ways, governments have significantly affected the **demand** for housing. However, the net effects on the **supply** of housing finance and its cost are less clear. The implications of government intervention for the stability of housing finance flows are discussed in Section B of this chapter. The implications for the cost and availability of housing finance are explored in Section C.[1]

37.5 The Committee has not sought to determine whether there is an 'appropriate' level of resources going into housing. This is an area of debate pervaded by social value judgments and is outside the Committee's terms of reference.

B. STABILITY OF HOUSING FINANCE FLOWS

37.6 Variability in housing finance flows is usually seen as reflecting fluctuations in general monetary conditions. A common theme of views put to the Committee is that controls on housing finance intermediaries also have destabilising effects on housing funds flows which impact severely on the housing sector.

37.7 Two aspects are relevant here:

- the variability of housing finance flows; and
- the special sensitivity of housing activity to financial/monetary conditions, largely reflecting the industry's relatively high dependence on credit.

37.8 A number of ways of reducing instability in housing finance flows have been canvassed.

(a) Conduct of Economic Stabilisation Policy

37.9 The Committee recognises that the housing sector must continue to be a major channel through which monetary policy influences economic activity, prices and employment. Nevertheless, it is of the view that the industry has in the past been subjected to excessive and unnecessary instability.

37.10 The Priorities Review Staff *Report on Housing* (1975)[2] concluded that fluctuations in general financial conditions were the single most important cause of instability in housing finance flows and housing construction activity.[3] Figures 37.1–3 tend broadly to support this conclusion. Figure 37.1 shows that fluctuations in general financial conditions, as measured by the monetary base, have been closely associated with variations in deposit flows into housing finance intermediaries. Nonetheless, it is also evident that other factors influence funds inflows; one such factor (which is discussed later) is the inability of housing finance institutions at times to adjust their borrowing rates in line with other market rates.

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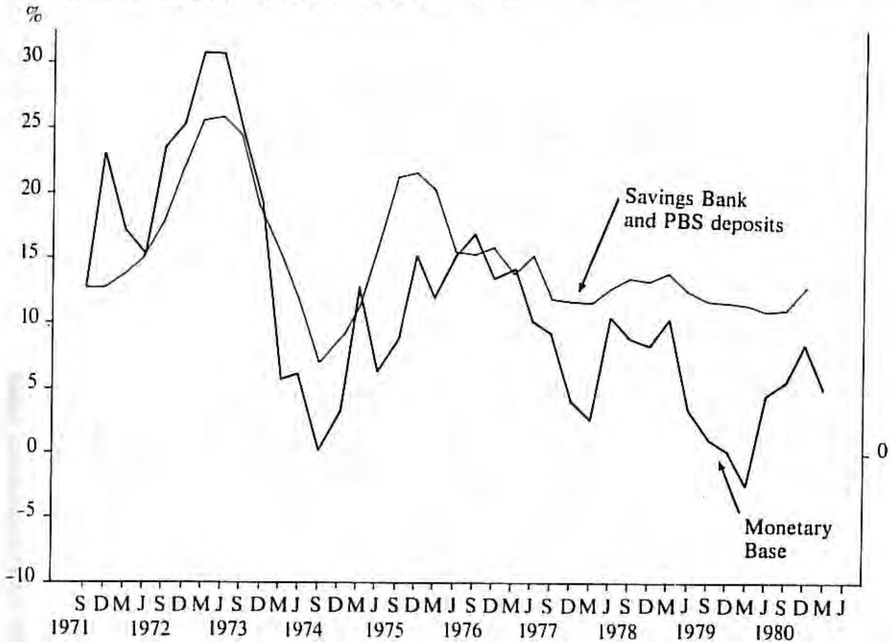
1 The Committee is mainly concerned with neutrality among borrowers, although the question of equity between borrowers and investors is also discussed in this chapter. Questions of competitive neutrality between intermediaries operating in the housing finance market, and between these intermediaries and other groups of intermediaries, are considered in Chapter 32.

2 Priorities Review Staff, *Report on Housing*, AGPS, Canberra, 1975.

3 The PRS Report examined evidence (up to 1974) of the relationship between general financial conditions and housing finance approvals (Appendix, Graph 6) and concluded that 'the correspondence is too striking for it to reflect only chance' (p. 48).

Figure 37.1: PERCENTAGE CHANGES IN MONETARY BASE AND SAVINGS BANK PLUS PERMANENT BUILDING SOCIETY DEPOSITS.[a] [b]



a) Quarterly data, expressed as a percentage change on the corresponding quarter of the previous year.
b) Monetary base, defined as currency on issue and deposit liabilities of the Reserve Bank to banks (excluding SRD and TLF/FDLF Accounts) and the public.

Sources: ABS Cat. Nos 5608.0, 5610.0

37.11 The fluctuations in funds inflows have clearly been reflected in housing finance approvals and construction activity. This can be seen from Figures 37.2 and 37.3.[4]

37.12 The Committee endorses the view of the Priorities Review Staff that **greater overall monetary stability can be expected to contribute substantially to the smoothing of fluctuations in housing finance flows and construction activity. Implementation of the Committee's recommendations in Chapter 3 would be a move towards establishing a more stable monetary environment.**

37.13 The Committee believes that a relatively stable monetary environment, coupled with flexible housing interest rates (discussed below), can be expected to ensure adequate housing stability. In its view, however, it would be inappropriate to attempt to insulate the housing sector from general monetary conditions. Such a course would have the effect of throwing a disproportionate share of the burden of monetary policy onto other sectors within the economy.

37.14 On the other hand, the housing sector should not have to bear a greater burden than other sectors. In fact, the continuing inability of housing financiers'

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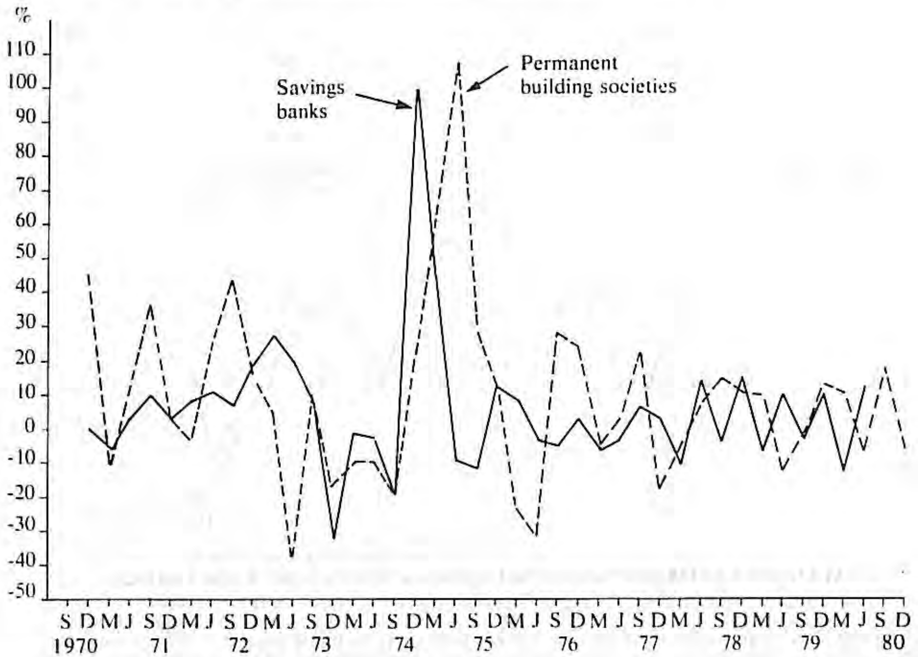
4 It is worth noting here that up to about 1978 building society approvals exhibited greater short-term variability than those of savings banks (see Figure 37.2). However, this has been less evident recently, suggesting more efficient planning of building society lending programs to take account of seasonal and other fluctuations in funds inflows.

FIGURE 37.2: QUARTERLY PERCENTAGE CHANGE IN HOUSING FINANCE APPROVALS [a] – SAVINGS BANKS AND PERMANENT BUILDING SOCIETIES



a) Loans approved to individuals for purchase of existing dwellings, construction of dwellings, and purchase of newly constructed dwellings
Source: ABS Cat. Nos 5608.0, 5610.0

interest rates to move fully in line with market-determined rates[5] has meant that their funds inflows have been affected to a greater degree by general variations in monetary conditions than other, less regulated intermediaries.

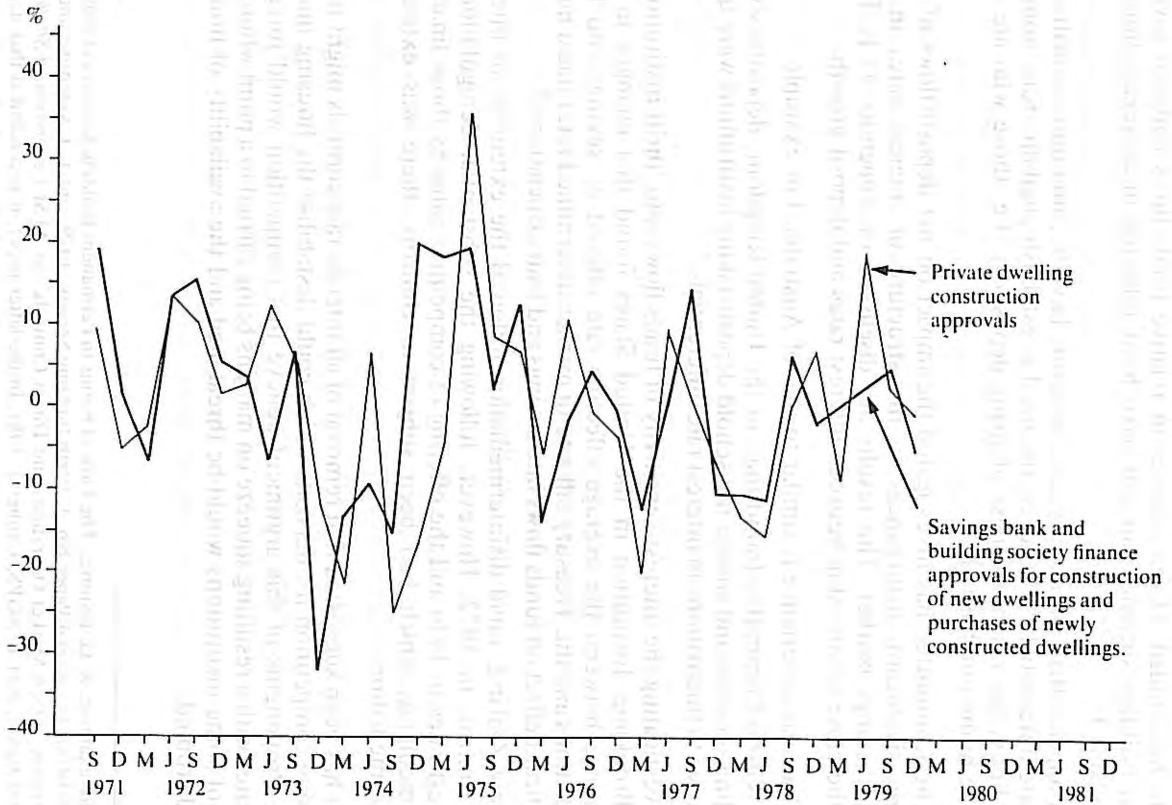
(b) Restrictions on Interest Rates

37.15 Savings banks are presently subject to a ceiling on the interest rate they may charge on housing loans of less than $100 000. Building society rates are only formally regulated in some states. However, even where rates are not formally regulated, suasion is often brought to bear — reinforced by the possibility that controls may be introduced if rates are raised above the 'desired level'.

37.16 Furthermore, so long as savings banks' lending rates continue to be controlled, and their ability to compete for deposits thereby inhibited, there is less pressure on building societies to lift their lending rates to market levels. That building societies do not usually set their rates at full market levels even in the absence of controls is reflected, for example, in the considerable waiting time for loan approvals that often occurs.

5 Official action to change controlled rates, especially when rates generally are rising, has typically lagged movements in market rates, and has not always taken full account of the competitive position of the borrowing intermediaries in the market for funds.

FIGURE 37.3: HOUSING FINANCE APPROVALS AND PRIVATE DWELLING CONSTRUCTION ACTIVITY.[a]



a) All variables measured in quarterly per cent changes

Sources: ABS Cat. Nos 1308.0, 5608.0, 5610.0; RBA *Statistical Bulletin*

37.17 The *a priori* case for removing interest rate controls is clear. Investors can be expected generally to be sensitive to differentials between interest rates offered by competing intermediaries, so that failure of housing finance intermediaries to lift their rates at a time of generally rising interest rates will, other things being equal, lead to a loss of deposits to competing intermediaries. It follows that rates should be allowed to move freely according to market forces if disruption to funds flows is to be avoided. (Even changes in relative funds flows between savings banks and building societies can and have been reflected in aggregate housing funds available.)

37.18 It appears that, in recent years, investors have become more sensitive to interest rate differentials.[6] However, the need to establish eligibility for a housing loan still limits the responsiveness of many depositors (i.e. those who are also prospective home purchasers).

37.19 The Committee has investigated the impact on net deposit flows of two particularly significant disturbances to the structure of interest rates in the household savings market. The results are discussed in Appendix 37.1. They confirm the close relationship between interest rates and deposit growth.

37.20 Overseas experience is similar to that of Australia. For example:

- The Wilson Committee found that, in the United Kingdom, depositors with building societies and similar household deposit-taking institutions were quite sensitive to fluctuations in interest rate differentials.[7]
- In investigating the interest-sensitivity of funds flows into 'thrift institutions', the Brookings Institution in the United States found that changes in the difference between the average effective rate offered by savings and loan associations and the Treasury bill rate (a market-determined rate) had a highly significant effect on funds flows into savings and loan associations.[8]
- In New Zealand, rapid disintermediation followed the extension of interest rate controls in 1972. However, following the substantial deregulation of interest rates in 1976 and the offering of competitive rates by those financial intermediaries which had been subject to controls, there was extensive reintermediation.[9]

37.21 It has been suggested that removal of all interest rate controls might result in excessive competition for deposits which could destabilise the housing finance industry. Proponents of this argument believe that competition would force up deposit rates with a resulting squeeze on margins being carried to a point where the viability of some institutions would be threatened and the availability of housing finance disrupted.

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6 See, for example, R. G. Elstone, 'The Flow of Funds to Permanent Building Societies in Australia (1968–1978), Occasional Paper No. 1, Perth Building Society, 1979, and T. J. Valentine and P. J. Williamson, 'Open Market Operations and Direct Controls', in AFSI *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981. In the latter paper, it is concluded that deposits with building societies (but not savings banks) are sensitive to changes in the finance company rate.

7 Report of the Committee to Review the Functioning of Financial Institutions (Wilson Committee), HMSO, London, June 1980, p. 85.

8 Dwight M. Jaffee and Kenneth T. Rosen, 'Mortgage Credit Availability and Residential Construction', *Brookings Papers on Economic Activity*, 2:1979.

9 R. S. Deane, Chief Economist, Reserve Bank of New Zealand, 'Lessons from an Overseas Financial System: The Case of New Zealand', *Economic Papers*, No. 63, Feb. 1980.

37.22 The Committee questions this view, for reasons discussed in Chapter 19. While some active interest rate competition for deposits will undoubtedly occur, there is nothing in the experience of unregulated intermediaries overseas to suggest that unfettered competition tends to cause widespread instability in finance flows.

37.23 The scope for competitive increases in interest rates is limited by the relative sensitivity of the **demand** for housing finance to such increases.[10] Given the average size of housing loans, a small percentage increase will generally mean a significant increase in repayments (where the term of the loan is not extended), which will impact on prospective borrowers. Borrowers for housing are more severely affected because:

- businesses can more readily afford higher rates to the extent that the interest expense on borrowings is tax deductible and can be passed on to final consumers; and
- smaller loans typically provided to the household sector for non-housing purposes (e.g. by banks, credit unions or finance companies) carry smaller repayments, so that borrowers are less likely to be discouraged by an increase in interest rates.

37.24 Soundly managed housing finance institutions are thus unlikely to bid up the price of funds beyond a level at which they could be on-lent (although it is possible some intermediaries might misjudge what the market will bear on occasion, and others might be prepared to accept short-term losses so as to increase their longer term share of the market).

37.25 If housing financiers were free to adjust their interest rates when market rates generally were increasing, there would then be no reason why the **supply** of housing finance would be more severely affected in times of credit restraint than other forms of credit. Monetary policy would be neutral in its effects on the supply of housing finance.

37.26 The Committee concludes that, **in the long run, housing financiers' inflows would be more stable if their interest rates were allowed to move in line with market forces.**[11] Coupled with greater overall monetary stability, interest rate decontrol may help appreciably to stabilise housing finance flows, especially as household sector investors have become more interest-rate sensitive. The reduced volatility in funds flows should contribute to a more stable housing sector over the long term. This might result in a slower growth in housing costs.[12]

37.27 Housing construction activity will, of course, continue to exhibit some degree of instability, reflecting the sensitivity of demand for housing to increases

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10 This has implications for the stability of housing finance institutions which are unable to diversify in the face of competition for deposits from other intermediaries with a broader portfolio or which lend substantially to businesses.

11 Some argue that an alternative would be to control interest rates of **all** intermediaries (e.g. under the Banking and Financial Corporations Acts), so that the pattern of interest rate differentials is not disturbed. The Committee strongly opposes this course for reasons outlined in Chapter 4. There are numerous examples of the rapid and wholesale disintermediation that can result; the sharp growth of 'money market mutuals' in the United States as a result of widespread interest rate controls is a case in point.

12 The Housing Costs Inquiry drew attention to the potential for greater stability in activity to have a dampening effect on the rate of increase in housing costs. *The Cost of Housing*, Report of the Committee of Inquiry into Housing Costs, AGPS, Canberra, 1978, p. 146.

in interest rates, and the dependence of purchasers of housing and home builders on credit.

(c) Matching of Maturities

37.28 It has been suggested that a better matching of the maturity of assets and liabilities, or at least a reduced dependence on call deposits, would reduce the vulnerability of many housing finance institutions to sudden surges in withdrawals associated with crises of investor confidence.

37.29 Any reduced dependence on call deposits to finance long-term lending must be considered more prudent and should reduce instability in housing finance flows. That said, the Committee would not go so far as to suggest that housing finance institutions should be **required** to match in any precise way the maturity of their assets and liabilities. Some particular considerations might be noted:

- most intermediaries perform a maturity transformation function;
- it is impracticable to achieve a high degree of matching, given the average duration of mortgages and the preference of investors for short-term investments;
- matching by term is less important to the extent that mortgages are at variable interest rates; and
- such a requirement would limit the flexibility of the intermediaries to respond to market conditions.

37.30 However, the need for the observance of certain liquidity and other disciplines where the maturity of assets and liabilities are not closely matched, and the costs associated with these disciplines, should be recognised. Sections of the community have also perceived a need for deposits insurance for building societies. While such arrangements should reduce some of the sharp fluctuations in the funds inflows of insured societies, and thus in their lending, they will also add — albeit marginally — to the cost of housing finance.[13]

(d) Diversification of Sources of Funds

37.31 Savings banks are not currently permitted to accept deposits from companies or others engaged in profit-making activities. To be taxed as a co-operative, building societies must have, as a primary objective, the obtaining of funds from their 'shareholders' for on-lending to their members.

37.32 It has been suggested that if housing finance intermediaries were allowed to broaden their sources of funds, the stability of funds inflows might be improved.

37.33 Consistent with its views on the need for flexibility, the Committee favours institutions being granted greater freedom to broaden their sources of funds including access to corporate and wholesale money markets.

37.34 It should be noted, however, that the need for greater diversification in sources of funds should be much less in the future. While there has been a degree of insulation in the past between wholesale and retail sources of funds, this is progressively breaking down as markets mature and become more integrated and better informed. Thus, factors which at present tend to impact disproportionately on household finance flows (e.g. the issue of ASBs at over-attractive interest rates) should in future have a less destabilising effect.

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13 The prudential implications of 'mismatching' are discussed in greater detail in Chapter 19.

37.35 However, the Committee would caution against any substantial or long-term dependence on short-term money markets in view of the particularly high volatility of interest rates in these markets.

(e) Establishment of Secondary Mortgage Market Agency

37.36 The proposal to establish a **government-run** secondary mortgage market agency as a means of stabilising housing finance flows is discussed at some length in Part II of this chapter, where it is concluded that such an approach is unnecessary and undesirable. The development of an Australian secondary mortgage market would undoubtedly be of some assistance to housing finance institutions, but once certain constraints (such as interest rates and high levels of stamp duty) are removed, there is no reason why this should not occur on a commercial basis.

(f) Conclusions

37.37 The Committee believes that the two most effective and logical steps that governments can take to reduce instability in housing finance flows are:

- to maintain overall stability in monetary growth (as discussed in Chapter 3); and
- to remove all interest rate controls and limitations on the deposit base of housing finance intermediaries.

C. EFFECTIVENESS, EFFICIENCY AND EQUITY

37.38 The key questions in assessing the effectiveness, efficiency and equity of assisting housing and home ownership through regulation of financial intermediaries are:

- the impact of interest rate controls on the cost and availability of finance;
- the distributional effects of interest rate controls; and
- the effects of portfolio constraints and other forms of government intervention.

37.39 These are partly empirical questions. The evidence used in the following analysis in addressing these questions is drawn primarily from a housing finance consultancy report commissioned by the Committee,[14] though other sources have been used where indicated. Analysis has been hampered by the fragmentary nature of data available.

(a) Interest Rate Regulation

(i) Effects on the Cost and Availability of Housing Finance

37.40 Concern has been expressed that interest rate deregulation will lead to an increase in interest rates. The consultancy report suggested[15] that, as a consequence of deregulation, the savings bank mortgage rate might be reasonably estimated to move up by some 3.5% to a level some 2% above the then existing bond rate.[16]

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14 Judith Yates, 'The Distributional Impact of Interest Rate Regulation on the Household Sector', in AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

15 ibid., Part I, Section 1.

16 The then prevailing bond rate was 13.1%.

37.41 There is no way of establishing precisely what levels, or structure, of interest rates would apply in a deregulated financial system. However, the inherent 'quality' of an investment secured by mortgage over residential land and buildings leads the Committee to question why housing finance rates should command a 2% premium over the government bond rate (typically viewed as the 'riskless rate of return'), even allowing for the expenses of writing and administering a loan.

37.42 One would expect the magnitude of any increase in interest rates to be constrained by the natural outworking of market forces, i.e. by the greater level of deposits attracted to housing finance institutions as a result of more competitive deposit rates and access to wider sources of funds, together with a contraction in the demand for housing finance as a result of higher lending rates.[17]

37.43 The effects of deregulation on the level of housing finance interest rates can best be examined by considering the factors influencing the supply of finance available at different rates.[18]

37.44 At present, the market for housing finance is highly segmented: a free market coexists alongside a 'controlled' market. In addition to the established housing finance institutions, other intermediaries such as finance companies and insurance companies engage in lending for housing — at varying interest rates. One particular source of housing finance that reputedly grows in importance when major lenders are constrained is solicitors' trust funds.[19]

37.45 Because of this segmentation of the housing finance market, the effect of deregulation of recognised housing financiers' interest rates might be that:

- some borrowers (those who borrow wholly or to a significant degree from unregulated financiers) would find finance more readily available and at lower cost; while
- other borrowers (those who borrow wholly or predominantly from regulated intermediaries) would find they had to pay more to secure finance.[20]

37.46 To the extent that borrowers who are unsuccessful in securing finance from the savings banks and permanent building societies due to interest rate

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17 The evidence of long-term interest rate differentials in the USA and Canada graphed by the Committee in Part II of this chapter should **not** be used as a basis for estimating the extent of any housing finance interest rate increase in a deregulated environment. In the USA home loan interest payments are tax deductible, lowering the effective cost of borrowing after tax, and thus allowing mortgage rates to be bid up beyond levels that might otherwise apply. Differences in institutional structure may limit the relevance of the Canadian situation.

18 Deregulation will not generally affect the 'demand curve' for housing finance: it will only alter the shape and slope of the 'supply curve'.

19 This is often characterised as a 'direct' form of financing in that it does not involve the recognised intermediaries. An informal survey conducted by the Committee amongst selected solicitors and mortgage finance brokers in February–March 1980 suggested that the value of outstanding loans might be of the order of about $5 billion of which about $2 billion was in NSW. Given the tight conditions experienced by the traditional lenders over much of the last year or so, this figure probably underestimates the current extent of such financing.

A similar role is also increasingly performed by some stockbrokers and specialist mortgage finance brokers. While solicitors probably still account for the bulk of direct financing, the others are understood to be growing in relative importance.

20 The distributional effects of interest rate regulation are discussed in paragraphs 37.58–81 (see in particular paragraph 37.72).

controls are currently being satisfied from other sources, deregulation may lead to changes in market shares between different lenders.[21]

37.47 As noted in paragraphs 37.21–24, in a deregulated environment it is possible that there may be increased interest rate competition for deposits. However, the Committee sees any problems from this source as essentially **transitional** in character.

37.48 The ultimate impact of any interest rate increases on prospective borrowers from savings banks and building societies may also be mitigated by a number of offsetting influences.

37.49 Firstly, in a more competitive environment lending business would be diverted from less efficient to more efficient intermediaries and lenders would have a stronger incentive to adopt more innovative practices and, in particular, to tailor loans to suit the needs and means of borrowers, including low income earners. Existing repayment 'rules', where maximum loan eligibility is related to income, are essentially a device for **rationing** funds in a situation of excess demand.[22] In a free market situation, any income-related restrictions should reflect only the lender's assessment of a borrower's capacity to repay.

37.50 The Committee would expect greater scope and commercial incentive to use 'income-geared' loans of the 'low start' or deferred repayment variety.[23]

37.51 The fact that permanent building societies, which have traditionally experienced a lesser degree of regulation than savings banks, have experimented with such innovations in recent years, and that finance companies which are unfettered in their operations have also become more innovative in their lending for housing, whereas savings banks have not, tends to bear out the correlation between freedom from regulation and incentive to innovate.

37.52 Secondly, those borrowers who have had to obtain alternative or supplementary finance at higher rates to meet their total requirements may already be paying effective overall rates as high as, if not higher than, a market rate for loans by housing finance institutions.

37.53 Thirdly, one significant element in the present 'cost' of a housing loan — viz. the need to maintain balances with a housing finance institution at controlled (below-market) rates in order to ensure future eligibility for a housing loan — would be largely eliminated.[24]

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21 In a perfect world this adjustment of market shares would be taken to a point where all housing finance is provided at the same (risk-adjusted) price by the most efficient intermediaries. In practice, there is likely to be some continuing segmentation of housing finance markets in a deregulated environment, though on a considerably lesser scale.

22 These rules, of course, also limit the likelihood of borrowers over-committing themselves and, to a lesser extent (reflecting also the existence of mortgage insurance), reduce the risk exposure of housing finance institutions.

23 The ABA has indicated that 'freedom from controls would enhance deposit-raising potential and provide incentives for greater innovation in lending' which 'could include the provision of variable terms and conditions for housing loans in particular, with greater flexibility in repayment programmes to suit the changing capacity of a borrower to service a debt during its currency'. ABA letter to the Inquiry of 20 November 1980.

24 It is acknowledged that lower-than-market rates, by raising people's expectations, might have stimulated greater saving with housing finance institutions (to establish eligibility for a housing loan) while portfolio controls have ensured that these funds are lent for housing. To the extent that lower-than-market rates have not caused a reduction in the flow of funds to housing they may have simply become capitalised into housing prices. To a degree at least, therefore, deregulation of interest rates may ease the upward pressure on the cost of housing. This would, in effect, partially offset any increase in borrowing costs.

37.54 **In brief**, the Committee does not believe that the effective **cost** of housing finance would necessarily rise appreciably on average as a result of the deregulation of interest rates.[25] Some increase **may** occur in the transitional period; however, in the longer run, while some will pay more and some will pay less, the average cost may not change much.

37.55 The effects of deregulation on the **availability** of finance are somewhat more predictable. As indicated in paragraph 37.18, investors can be expected generally to be sensitive to relative interest rates offered by competing intermediaries; deregulation will thus tend to make housing funds more readily available from housing finance specialists (albeit at slightly higher interest rates).

37.56 It is argued by some, however, that deposit growth is strongly correlated with the prospect of obtaining home loans on relatively favourable terms, and will be adversely affected if the concessional element is removed.[26] It is probable that any weakening in the growth of prospective borrowers' deposits is likely to be more than outweighed by the effects on other investors of more competitive savings bank and building society interest rates.

37.57 The Committee now turns to the 'welfare', or 'distributional', aspects of interest rate regulation and deregulation.

(ii) Distributional Effects

37.58 Governments of all political persuasions have sought to facilitate access to home ownership across the widest range of income groups. This objective has been popularly translated into improving access for lower income groups and first-time home buyers especially. Interest rate controls have been used for this purpose. (Other means employed are discussed later.)

37.59 However, it has been suggested that lower income groups and first-time home buyers only receive a small proportion of the perceived benefits from these controls because:

- many borrowers from regulated housing finance institutions have relatively high incomes; low income earners are less likely to be able to obtain a 'rationed loan' than higher income earners;[27]
- the **indirect** effects of the controls have tended to disadvantage lower income groups; and
- lower income groups are likely to hold a higher proportion of their savings in the form of deposits with housing finance institutions.

37.60 The natural response of intermediaries which are unable to pay a sufficiently high rate on deposits to attract sufficient funds to meet the demand generated by the existence of lower-than-market lending rates is to ration funds to borrowers. As there is no scope to allow for greater risk in the interest rate charged, lenders will tend naturally to prefer those with higher income and/or wealth.

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25 The effects of other government controls, such as portfolio constraints, are discussed separately later.

26 The number of investors with building societies for each borrower has risen steadily throughout the 1970s, from 6.5 investors at end June 1978 to 12.9 at end June 1980. This appears to reflect the use of building society accounts as 'current accounts' and the increasing average size of home loans. A similar trend is evident in the case of savings banks.

27 References to 'higher income groups' should be regarded strictly as a **relative** concept. High income earners generally would not be affected, as they tend not to rely on regulated financial intermediaries for housing finance.

37.61 Three non-price rationing devices that have typically been used, especially by the savings banks, are the application of:

- maximum loan-to-valuation ratios, where the maximum loan size is determined on the basis of maximum allowable percentages of the valuation of the house or unit;
- absolute maximum loan sizes (i.e. irrespective of income or valuation of property); and
- income-related repayment rules, where the maximum loan size is determined on the basis of repayments set at some maximum percentage of income at the time of application.

37.62 These rules tend to make it difficult for lower income earners, and particularly first-time buyers,[28] to obtain loans, as these generally require a larger relative loan but have greater difficulty in servicing it.[29]

37.63 However, the availability of mortgage insurance has lessened the impact of the first of these rules. Some building societies have also sought to overcome the discrimination problem inherent in the debt service constraint by introducing special repayment arrangements such as deferred repayment mortgages. Nevertheless, rationing devices continue to discriminate against low income earners.

37.64 The Committee has sought to evaluate the effects of rationing on low income earners. Ideally, such an evaluation would involve a comparison, at the time of the borrowing application, of the income, wealth and age characteristics of successful and unsuccessful applicants.

37.65 However, there is insufficient up-to-date information to adopt this approach. In particular, reliable data on prospective borrowers and their income and other characteristics, and on whether or not they are seeking to purchase their first home, are not available.[30]

37.66 The Committee has therefore undertaken a more selective examination, comparing the income characteristics of the total (adult) population with those of a sample of borrowers from a few savings banks and permanent building societies. The results of this examination are presented in Table 37.2.

37.67 It can be seen that the income distribution of borrowers obtaining finance from savings banks and permanent building societies is very much out of line with the population income distribution, the lower income range being conspicuously underrepresented.

37.68 Of course, one would not expect the income distribution pattern of prospective housing borrowers to be the same as that of the total adult population,

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28 It is also reasonable to expect that those buying a house for the first time generally have a smaller deposit than those who have already owned a home, even assuming similar income and overall propensity to save.

29 There is a rough but nonetheless discernible correlation between income of borrower, price of house, loan size, and thus the size of 'subsidy' obtained where finance is obtained at lower-than-market rates. The percentage-of-income repayment rules typically used to determine maximum loan size tend to strengthen the association between income and loan size for most borrowers. Thus there is arguably an automatic tendency for the 'subsidy' to be regressive, even if lenders do not explicitly give preference to higher income earners.

30 The full range of data problems is outlined in Yates, op.cit.; see especially Part I.

TABLE 37.2: COMPARISON OF TOTAL ADULT POPULATION AND HOUSING BORROWER INCOME DISTRIBUTION — 1979–80

Income range ($ per week)	*% of all income units*[(a)]	*% of NSW savings bank borrowers*	*% of Victorian savings bank borrowers*	*% of NSW building society borrowers*
185 or less	45.1	3.4	3.2	4.3
186–245[(b)]	13.0	10.3	9.6	12.4
246–325	15.5	18.4	21.8	21.8
326–385	7.7	18.6	13.8	15.9
Greater than 385	18.7	49.3	51.6	45.6

(a) Income unit data are drawn from the 1978–79 Income Survey by the Australian Bureau of Statistics. The figures have been adjusted to bring them into line with the 1979–80 data for the rest of the table by allowing for a 10% increase in incomes. As the income groupings do not coincide with those to which the other data relate, it was necessary to interpolate within income groupings, making the assumption that incomes are distributed uniformly within each ABS classification.

The remainder of the table relates to households rather than income units, the major difference being that non-dependent children living with their parents are classified as one person income units. This has the effect of skewing the income distribution towards the lower end of the income scale.

(b) Approximately equal to 1979–80 average weekly earnings.

Source: Compiled from Yates, op.cit., Part II, Tables 1.2a, 2.2, 2.10 and 3.3.

not least because of differences in age composition. Nonetheless, the differences shown in Table 37.2 appear to be too marked to be explained solely in those terms.

37.69 Thus, it is reasonable to conclude that the flow of funds from housing finance institutions is 'skewed' against lower income earners and favours higher income earners.

37.70 The **indirect effects** of controls are also important. Controls have forced many borrowers who are unable to obtain sufficient finance from housing finance institutions to resort to:

- supplementary second mortgage finance; and
- more expensive alternative sources of finance (life offices, finance companies etc.).

37.71 Sample survey data available to the Committee[31] indicate that about 8% of all borrowers having a first mortgage loan from one or other of the recognised institutional lenders also have a second mortgage loan as supplementary finance. Although this figure is not particularly large, it may underestimate the true extent of demand for supplementary finance to the extent that other loans, not secured by second mortgage, are used to bridge the 'deposit gap'. Moreover, second mortgage loans are typically short term. The survey therefore includes many mortgagors who may once have had second mortgage loans but have since repaid them. It follows that a similar survey of **recent** borrowers would have shown a much higher proportion with second mortgage loans.

37.72 The need to seek supplementary finance typically involves the borrower in higher costs, since funds are obtained from less regulated sources (e.g. finance companies) charging higher rates. The overall cost of funds — comprising the lower rate charged by the regulated source and the higher rate charged by the unregulated, supplementary source — may often be higher than a savings bank or

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31 'Investments and Savings, Australia, December 1980', McNair Anderson report commissioned for the Australian Financial System Inquiry. See AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

building society would charge for a single loan if they were allowed to charge a market rate.

37.73 Thus the policy of promoting access to home ownership by lower income groups through the regulation of interest rates would appear to have been largely ineffective.

37.74 In respect of its impact on **depositors**, there is evidence to suggest that savers with the regulated housing financiers bear much of the cost, in the form of interest income forgone due to below-market deposit rates. Table 37.3 indicates that lower income earners hold a considerably greater proportion of their wealth in savings bank passbook accounts than do higher income earners.[32] The trend is much less evident in the case of savings with building societies.

37.75 To the extent that those on higher incomes are more likely to hold **non-financial** assets (e.g. real estate, art, antiques, coins etc.) these figures in fact **understate** the impact of controls on low income earners relative to higher income groups.

TABLE 37.3: DEPOSITS WITH SAVINGS BANKS AND PERMANENT BUILDING SOCIETIES AS A PROPORTION OF TOTAL FINANCIAL ASSETS, BY INCOME (%)

Household income ($)	*Savings bank passbook accounts*	*Savings bank investment accounts*	*Building society accounts*
9 999 or less	43.3	4.4	16.0
10 000–14 999	26.9	11.5	17.2
15 000–19 999	30.3	11.4	15.7
20 000–24 999	18.9	10.2	16.4
25 000 and over	15.7	11.1	15.4

Source: Derived from Yates, op.cit., Part I, Table 2.15

37.76 **In summary**, interest rate controls are an inefficient and ineffective means of assisting low income potential home buyers. They have regressive distributional consequences, harming many of those they are intended to benefit, and benefiting many who do not require assistance. In short, they can be said to have been **counter-productive** in achieving their welfare objectives, while hurting the community at large by impairing the efficiency of the financial system.

37.77 The Committee therefore concludes that **there is no justification for retaining interest rate controls as an instrument of housing or welfare policy.**

37.78 Any increase in the cost of housing loans that may occur as a result of deregulation will, of course, lead to an increase in repayments unless the term of the loan is extended. It has been suggested by some that such increases in repayments will become more commonplace as the capacity of housing finance institutions to extend the term of loans diminishes, resulting in widespread hardship.

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32 Yates also concluded, on the basis of the Macquarie University Survey of Consumer Expenditures and Finances in 1966–68, that as low income renters hold a much higher proportion of their total net worth in savings bank deposits than low income home owners, any restrictions on interest rates result in their earning a lower average rate of return on all their assets compared with higher income households and owner-occupiers (Yates, op. cit., Part I).

37.79 The extent to which increases in interest rates cause hardship to individuals depends, of course, on the size and frequency of the increases relative to the growth in earnings. The Committee notes that, if all interest rate increases had been passed on in the form of higher repayments over the two years to February 1981, the increase in repayments would, in fact, have been less in percentage terms than the growth in average weekly earnings.[33] This test is not, of course, conclusive (as interest rates and earnings are constantly changing).

37.80 Those persons most likely to be affected by sizeable interest rate increases are those who have not yet acquired their first home (but who have been disadvantaged by deposit rates having been held down) or who have borrowed recently and whose repayments are a high proportion of their income. The Committee has already noted that if its recommendations are adopted, lenders should have the incentive to adopt more innovative practices and, in particular, to tailor loans to suit the needs and means of borrowers. The Committee expects that, in raising interest rates on home loans subsequent to deregulation, housing finance institutions will, of their own accord, have particular regard for the burden on those borrowers who are least able to afford increases in loan repayments.

37.81 The Committee acknowledges that governments may wish to protect certain sectors of the community, especially low income earners, against possible increases in interest rates. Some of the options that governments might consider adopting are discussed later.

(b) Other Forms of Government Intervention

(i) Portfolio Constraints

37.82 Elsewhere in the Report the Committee has looked at the balance sheet ratios applying to savings banks and permanent building societies. In Chapter 10 it focused on the so-called '40% ratio' for savings banks and recommended its abolition. In Chapter 19 the liquidity and other ratios appropriate to these institutions in the context of overall prudential regulation were discussed.

37.83 The so-called '100% ratio' which restricts savings bank assets largely to investments in the government sector and in housing, while having important prudential objectives, can be viewed in part as having some relevance for housing policy. To maintain the availability of housing finance, successive governments have gradually permitted the proportion of housing loans to rise from 30% to 60%

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33 Taking the period February 1979 to February 1981, average weekly earnings rose by 23.3%; disposable income (i.e. after tax) of a person on average weekly earnings rose by 22.5% over this period. A profile of typical savings bank and building society loans and repayment schedules indicates that repayments have risen at a slower rate.

Savings banks:

February 1979 — average loan approved was $23 333; monthly repayments on a twenty-five year loan at the then predominant rate of 9% p.a. were $196.67.

February 1981 — with the increase in interest rate to 11.5%, monthly repayments were $237.06, an **increase of 20.5%.**

Building societies:

February 1979 — average loan approved in NSW was $28 667; monthly repayments at 10.25% (the mid-point of rates charged by NSW societies) were $265.46.

February 1981 — with the increase in the interest rate to 12.25%, monthly repayments were $307.31, **an increase of 15.8%.**

Similar calculations for Victorian building societies, whose rate rose from 11.75% to 12.5% over the same period, indicate **an increase in monthly repayments of 4.6%.**

of depositors' funds and permitted a reduction from 10% to 7.5% in the proportion of the assets savings banks are required to hold in deposits with the Reserve Bank and Treasury notes.

37.84 In his 1978 Budget Speech the Treasurer announced that the Banking (Savings Banks) Regulations were to be reviewed with the intention of giving banks more flexibility in determining the composition of their assets. The Treasurer recently announced that the review had been completed but that changes to the regulations would be deferred until the Government had considered the Committee's report.

37.85 In Chapter 19 the Committee advocated replacement of the restrictions on savings bank assets with other prudential requirements, including the maintenance of appropriate 'asset quality/capital' ratios. It is believed that financial intermediaries should be allowed maximum portfolio flexibility: those intermediaries that wish to **specialise** in housing might continue to do so, but lending for housing **as part of a diversified range of activities** should also be permitted. In practice, with intermediaries free to pay market rates on their deposits and charge market rates on their loans, it is most unlikely that any substantial move out of housing would occur, at least in the short to medium term.

37.86 Similar questions arise in regard to the balance sheet structure of permanent building societies: at present these institutions are only permitted to lend on the security of mortgages over land.[34] Funds not used for loans can only be applied to a restricted range of approved investments.[35]

37.87 From the viewpoint of housing, the Committee sees no justification for retaining these requirements on savings banks and building societies. Consistent with the views put forward elsewhere in this Report — and especially in Chapter 10 in regard to captive market arrangements for public securities — it might be argued that:

- there are doubts about their long-run effectiveness in achieving their sectoral objectives;
- the distributional effects are arbitrary and often perverse;
- it is more cost-effective to provide sectoral assistance through direct fiscal subsidies wherever possible;
- in a rapidly changing financial and economic environment, it is important for allocative efficiency and stability reasons that institutions be free to respond flexibly to innovation and investment opportunities; and
- portfolio constraints selectively applied only to one group of institutions are not consistent with the principle of competitive neutrality.

37.88 Having regard for the overall security of the assets concerned, those intermediaries wishing to specialise in housing would, particularly when the loans are covered by mortgage insurance, be subject to a smaller capital requirement

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34 NSW, Victoria, Queensland, ACT and the Northern Territory also permit loans to members on the security of their shares or deposits. It should be noted that building societies are not precluded from lending to home owners for the purpose of financing the acquisition of consumer durables provided these loans are covered by the underlying security of mortgages.

35 See Interim Report, paragraphs 15.64–65 for details of the investments permitted.

(and thus have a higher gearing ratio) than those which undertake more risky forms of lending.[36]

37.89 The Committee also believes that there should be appropriate communication and consultation with shareholders, members and depositors before any substantial diversification of an intermediary's assets is undertaken, given the basic change in the nature and security of their investment.

37.90 The Committee is mindful that the portfolio constraints on savings banks and building societies are imposed by Commonwealth and State Governments respectively. It is desirable that reforms in this area be synchronised as far as practicable so that no one group of institutions gains a competitive advantage over another.

37.91 Accordingly, the Committee ***recommends*** that, **subject to appropriate prudential requirements — most important of which would be asset quality/capital ratios — the present restrictions on the asset structures of savings banks and permanent building societies should be removed. Shareholders/members should approve any substantial diversification of an intermediary's assets. Depositors should be advised of the changes after such approval has been received, and term depositors should be given the option of withdrawal of their funds.**

37.92 If, notwithstanding the Committee's view that any short-term disruption to housing finance flows is unlikely, there were concern about possible short-run implications, consideration might be given to introducing these proposed changes progressively.

(ii) Lending Directives

37.93 As already indicated, the Committee believes that the deregulation of interest rates should enable permanent building societies and savings banks to adopt a more flexible approach to the needs of different borrowers.

37.94 It follows that it does not share the views of those who have suggested that regulation should be used to channel more private funds to low income earners forcibly through terminating or co-operative housing societies. Specifically, it has been suggested that savings banks and building societies should be required to allocate 5% of their housing lending to terminating societies. This would be most undesirable as it would mean that depositors would have to accept lower returns or other borrowers pay a higher rate, or both. This is not an equitable method of assisting low income groups.

37.95 Similar comments apply to suggestions that government and semi-government superannuation funds should be directed to lend to terminating societies. While it is sympathetic to the needs of low income earners, the Committee does not believe that beneficiaries of superannuation funds should be singled out to bear the cost of assisting the poor to obtain housing finance.

(iii) Official Suasion on Financing Techniques

37.96 The Housing Costs Inquiry recommended that 'financial institutions

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36 The question also arises, of course, whether institutions that no longer specialise in housing should continue to be categorised as 'savings banks' and 'permanent building societies'. It is difficult to believe, for example, that an organisation that does not lend substantially for housing could be called a building society.

should be encouraged to tailor terms and conditions for loans to meet the particular home finance needs of people with moderate incomes, particularly single income families'.[37] Similar suggestions have been put to the Committee; these include:

- a reduction in the initial rate of interest charged;
- an increase in the repayment period;
- indexation of repayments; or
- equity participation for lenders, i.e. where lenders have an entitlement to a share in the capital gains accruing on houses in exchange for lower rates of interest.

37.97 The Committee notes again here that deregulation of housing finance institutions should encourage innovation in this area **without** any government intervention.

37.98 It has been suggested that the major institutional lenders should be 'encouraged' to give preference to newly constructed dwellings, so that lending may have a more direct impact on housing construction activity. As well, the Commonwealth Banks Act requires the Commonwealth Trading and Savings Banks, in making housing loans, to give preference for the erection of homes and for the purchase of newly erected homes (s.56). The Committee does not favour lending 'requirements' of this kind. Intermediaries should be free to undertake lending which they judge to be in their own commercial best interests.

37.99 In the interests of competitive neutrality vis-a-vis other banks, the Committee ***recommends*** that **the provision in the Commonwealth Banks Act requiring the Commonwealth Trading and Savings Banks, in making housing loans, to give preference for the erection of homes and for the purchase of newly erected homes should be repealed.**

(iv) Fiscal Assistance

37.100 The Committee is aware of the concern of governments about the possible adverse impact of a less constrained financial system on housing borrowers, particularly low income borrowers. However, the Committee reiterates its belief that low income groups are most unlikely to suffer as a result of deregulation, and that interest rate controls have tended in the past to have generally **regressive** distributional effects.

37.101 Nonetheless, the Committee readily accepts that there will continue to be a section of the community needing assistance to buy (or rent) adequate housing. The community will expect their needs and expectations in the matter to be considered. Before considering what action, if any, governments might take, the limits of any possible problem need to be considered. In this chapter it has been concluded that relaxation of controls on housing lenders is likely to:

- increase the overall availability of housing finance;
- lower the interest cost of housing finance for those who presently borrow wholly or to a significant degree from unregulated intermediaries; and
- raise the interest cost of housing finance for those who presently borrow wholly or predominantly from regulated intermediaries.

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37 *The Cost of Housing*, op.cit., p. 136.

37.102 The Committee notes that, during the course of 1981, following some partial deregulation of the financial system, but essentially reflecting a diverse range of economic changes bearing on interest rates generally, there have been substantial rises in the average interest cost of housing loans. In the event of further deregulation, additional increases could probably be expected on loans from presently regulated institutions, although these may well be smaller to the extent that their rates are now closer to 'true' market levels. (The factors identified in paragraphs 37.48–54 are also relevant as are the comments in paragraph 37.76.)

37.103 Clearly, the point of any concern at present would be the **cost** rather than the availability of finance to those in lower income groups. Many in these groups are 'rationed out' of loans from regulated institutions; they are unable to service loans of any significant size from unregulated intermediaries and any increase in interest rates on loans from regulated intermediaries can only cause similar problems. They have difficulties also in closing the deposit gap. The problem for many in these groups is likely to remain.

37.104 In Chapter 36, the Committee expressed the view that where there was a distributional inequity, it should ideally be corrected by a general welfare measure. Credit-specific methods of assistance were seen to be 'second-best' solutions from an efficiency or welfare point of view.

37.105 The Committee nonetheless recognises that governments may wish to assist certain groups in a manner **specifically directed to the facilitation of home ownership (or house rental)**. For the reasons set out in Chapter 36, this assistance should be dispensed fiscally rather than through regulation of interest rates or credit controls.

37.106 Where a decision is taken by governments to assist lower income groups, it is the Committee's view that, in the interests of an efficient financial system, such assistance might desirably take one or other of the following forms:

- 'tied' cash grants direct to eligible purchasers to assist them to bridge the deposit gap;
- 'tied' cash subsidies direct to eligible borrowers to reduce interest costs (or rental), e.g. 'housing voucher' schemes; or
- interest rate subsidies, channelled through commercial intermediaries, to eligible borrowers.

37.107 The Committee's views recognise that:

- budgetary implications will be of utmost importance;
- some forms of assistance only benefit those who can gain access to housing finance; a major problem is the inability of many potential borrowers to bridge the 'deposit gap';
- any assistance that is confined to borrowers will, in itself, create an inequity between home owners and renters;[38] and
- any incentives for home ownership which encourage people to save with housing finance institutions may create a distortion in the pattern of savings.

37.108 The Committee does not seek to advise government in respect of further measures of fiscal assistance. To the extent that assistance is channelled through

38 Rents tend, of course, to rise when interest rates rise.

financial intermediaries, it is important that no distortions are created in saving patterns.

37.109 The Committee can appreciate why governments might wish to use tax deductibility of housing loan interest payments as a means of giving **limited** assistance specifically to **low income** groups and confined to the early years of a loan when the impact of high interest rates is likely to be greatest. However, it does not consider that, having regard for the present overall tax framework, interest payments on house mortgages should be **generally** tax deductible. Issues of such general principle are more properly assessed in the context of general taxation policy.

II SECONDARY MORTGAGE MARKETS

A. BACKGROUND

37.110 A secondary mortgage market (SMM) may involve trading in the actual individual mortgages themselves; generally, however, it has taken one of three other forms (although combinations are possible):

- A 'pass through' market, where writers of primary mortgages sell these to secondary mortgage institutions which in turn form large pools of mortgages against which medium to long-term participation certificates are issued to investors. The owners of these certificates jointly own the pool of mortgages and share in monthly payments of interest and principal.
- A market in mortgage-backed bonds, where a pool of mortgages provides collateral to secure repayments of principal; ownership of the mortgages does not 'pass through' to owners of the bonds.
- A 'bill issue' market in which writers of primary mortgages issue short-term bills backed by their mortgage portfolio. The primary aim of those issuing the bills is to even out shorter term (e.g. seasonal) fluctuations.

39.111 In some countries, particularly in the USA, governments have taken an active role in the operation and development of secondary mortgage markets through the formation of government agencies which purchase mortgages from housing finance institutions and either hold significant portfolios of mortgages in their own right or sell them to the general run of investors in the market.[39]

37.112 While there has been public discussion about the possible establishment of a SMM in Australia since at least the mid 1960s, it is only since about 1977 that a market in secondary mortgages and mortgage-backed securities has begun to evolve.

37.113 At least one company has been active in arranging for the sale and transfer of individual fixed-rate mortgages. Mortgages listed for sale are supported by a valuation and title abstract and are sold at **market** rates of interest. In return for a fee, the seller continues to collect repayments and/or interest which he passes on to the buyer. Returns on mortgages which carry a fixed interest rate lower than the prevailing rate are equalised through the buyer paying less than the face value

39 The forms of secondary mortgage markets which presently exist overseas are examined in more detail in Appendix 37.2.

of the mortgages. Buyers incur initial costs of registration and transfer, and sellers a brokerage fee of 0.5% of the sale price. The mortgages traded have a maturity of from six months to five years.

37.114 A 'pass-through' market dealing in negotiable mortgage-backed securities has been established in Victoria. The private mortgage company issuing the securities collects all mortgage payments from borrowers and passes them on to the holders. It collects a variable management fee of around 0.5%. Its obligations under this arrangement have been insured by way of fidelity bonds. The securities and mortgages are lodged with a bank nominee company which acts as trustee for those beneficially entitled to the securities.

37.115 The main purchasers of the securities are understood to be individual investors, superannuation funds and local and semi-government instrumentalities. The securities issued relate to individual mortgages of about $60–70 000 value, for terms of one to five years, and are insured (by the HLIC exclusively) for the full repayment of capital and interest. To date some 2500 securities have been issued, with an outstanding value of about $130–140 million. So far very few **transfers** of the securities are understood to have taken place, for reasons discussed later.

37.116 At least one other company is actively engaged in the issue of similar mortgage-backed securities, while another issues mortgage-backed bills. In the latter case, mortgages are lodged with a trustee company which assembles them into pools against which commercial bills are drawn.

37.117 There are two main issues to be considered:

- the potential contribution that the further development of a SMM could make to the Australian financial system, particularly in relation either to stabilising housing finance flows or improving the distribution of housing finance; and
- the appropriate role, if any, for governments, either in creating the preconditions for further development or by direct involvement.

B. POTENTIAL CONTRIBUTION OF A MORE DEVELOPED SECONDARY MORTGAGE MARKET

37.118 Submissions have claimed that the development of an active secondary market in mortgages would:

- improve the efficiency with which resources are allocated by encouraging greater integration between mortgage financiers and other sections of the capital market — and in the process increase the availability of housing finance;
- improve the stability of housing finance flows; and
- facilitate the transfer of funds between areas of excess demand and excess supply, including across state boundaries, thereby lowering the cost to (some) borrowers and raising the returns to (some) lenders.

37.119 The following discussion assumes that the regulatory and fiscal impediments to the development of a SMM, which are discussed later in this chapter, are removed and that, except where indicated, no government participation is involved.

(a) Availability of Housing Finance

37.120 It is argued that a developed SMM will facilitate greater intersectoral mobility of funds and thereby increase the availability of housing finance. This is based on the assumption that a SMM will enable mortgage originators to tap new sources of funds, particularly from long-term intermediaries such as insurance companies and superannuation funds.

37.121 The potential size of the market for mortgage-backed securities is difficult to assess. The following considerations are relevant:

- Long-term savings intermediaries have attracted a declining share of total financial assets during the 1970s (see Table 3.3. of the Interim Report). Even if this trend were reversed — and the recommendations elsewhere in this Report will have a significant bearing on this — the capital requirements of the resources sector in the 1980s are likely to constitute a major competing demand for funds.
- The development of a SMM, for the most part, is likely to attract investors whose investments would, in any event, have been directed toward the housing sector (e.g. those investing in mortgages through solicitors or even investors who would otherwise invest with building societies for a fixed term).
- On the other hand, it is possible that the liquidity which a well-developed SMM offers might attract investors, including short-term fund managers, who would otherwise have invested in other non-housing-oriented assets.
- Deregulation of the interest rates of housing finance institutions could also be expected to increase the capacity of these institutions to participate in a SMM. In periods of buoyant housing demand, the ability to raise funds by disposing of mortgages through a SMM may increase their ability to lend, which could in turn stimulate deposit growth.[40] (To the extent that they are able to liquidate mortgages at short notice, building societies may also be able to run smaller liquidity ratios.)[41]

37.122 The net effect of these factors is difficult to assess. However, in a deregulated environment, it seems reasonable to expect that an active SMM might widen the sources of funds for housing in the long run.

(b) Stability of Housing Finance Flows

37.123 A well-developed SMM might have some potential to smooth out cyclical fluctuations in the flow of funds to housing. This is because it might enable housing finance institutions to tap alternative sources of funds at times when the household savings market is under greater turmoil than other financial markets (e.g. as a result of the competitive impact of ASBs).

37.124 This would only occur, of course, if the interest rate on mortgages or mortgage-backed secuities were pitched at market levels and if there were a degree of 'segmentation' between the various financial markets. In practice, one would expect **some** market segmentation to persist in the future, although to a lesser extent than now.

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40 Building societies could, of course, issue mortgage-backed securities to raise additional funds as an ongoing method of supplementing deposit growth, in much the same way as savings and loan associations have done in the US.

41 Various factors bearing on building society liquidity, including a SMM, were discussed in Chapter 19.

(c) Regional Distribution of Funds

37.125 A more developed SMM could act as a vehicle for the transfer of mortgage funds between areas of excess supply and excess demand, as has happened in the United States (see Appendix 37.2).

37.126 It is important not to exaggerate the degree to which the Australian capital market is regionally fragmented (see Chapter 42); but to the extent that such a problem exists, it could be alleviated by an SMM.[42] It is likely that the development of the private SMM in the United States has been partly stimulated by the fact that financial institutions cannot, for the most part, fully trade across state borders.[43]

37.127 This situation can be contrasted with countries like the United Kingdom where the financial markets are national and so do not need, to the same extent, a SMM to transfer capital from surplus to deficit areas. Australia lies somewhere between the UK and USA in terms of the national/regional orientation of its financial institutions.

C. IMPEDIMENTS TO THE DEVELOPMENT OF A SECONDARY MORTGAGE MARKET

37.128 Two types of impediment to the development of a SMM in this country have been drawn to the Committee's attention, namely:

- those associated with the characteristics of the mortgages originated by the major housing financiers; and
- those associated with government taxation of financial transactions and/or regulation of financial institutions.

(a) Characteristics of Mortgages

(i) Variability of Interest Rates

37.129 It has been said that the variability of interest rates on housing mortgages has tended to inhibit the development of a SMM because investors have been uncertain as to the income stream which would be produced.

37.130 While the market that has developed in Australia to date has only been in fixed-interest mortgages, the Committee sees no reason why a viable market based on variable interest mortgages could not develop. The certainty attaching to income from fixed-interest securities is, in some respects, illusory. It should be noted that:

- although at any one time a precise present value can be calculated for fixed-interest securities by discounting their expected future cash flows by some appropriate discount rate, the discount rate will change as interest rates change;
- with unknown future rates of inflation, a certain nominal return represents an uncertain real return; and

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42 The regional problem would also be eased by allowing building societies to operate nationally and to trade mortgages interstate. This issue is taken up in Chapter 19.

43 Another important consideration is that in some states there are usury ceilings making it unprofitable for institutions to lend money raised in those states by way of mortgages.

- the tendency for institutions to adjust their portfolios in the light of changing market conditions means that securities are often not held to maturity; certainty of income counts for little if securities can only be sold at a capital loss.

37.131 It has been suggested that institutional investors such as life offices and superannuation funds may not be interested in holding variable rate mortgages or mortgage-backed certificates. This reflects concern about who would review the rates on such mortgages or certificates, how often the reviews would be undertaken and what repayment rights or options rest with borrowers.

37.132 The key point regarding the acceptability of variable rate mortgages for investors is that the interest rate must be determined by **the market** rather than at the discretion of government, vendors etc. So long as potential buyers of mortgages feel that governments may intervene to hold down interest rates on their mortgages at a time of generally increasing rates, an active market in variable rate mortgages is unlikely to develop.

37.133 It is worth noting that variable rate mortgages have begun to be marketed successfully in the United States, where there is an index which moves in line with trends in financial markets, to which saleable mortgages are tied.

(ii) Marketability

37.134 Unlike other securities markets, the primary mortgage market is in effect a series of overlapping sub-markets characterised by 'one of a kind' deals involving special considerations and local orientation. Mortgages vary in respect of:

- size
- term to maturity
- method of repayment
- the location, type, age and quality of the security offered
- the creditworthiness of the borrower

37.135 This diversity is seen as constituting an effective barrier to a SMM.

37.136 The small **size** of most individual mortgages is said to inhibit institutional investment in mortgages because of the transaction costs involved and the existence of economies of scale in originating and servicing housing mortgages. That institutional investors prefer large-scale investments is, however, no real impediment to the establishment of a SMM in mortgage-backed securities, which involves a 'pooling' of mortgages. The infant Australian market in such securities has already demonstrated the potential for attracting institutional investors.

37.137 Similarly, variations in the **term to maturity** should not be a problem as it should be possible to assemble a pool of mortgages with similar maturities. (In 1976, the housing mortgage stock comprised some 1.3 million mortgages,[44] of which the majority would have had — when originated — a term of beyond ten years.)

37.138 The **method of repayment** of mortgages varies from interest-only loans with repayment of principal at maturity to the credit foncier system of equal repayments over the life of a mortgage (embodying a changing proportion of interest and principal). While the former lends itself well to a secondary market,

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44 1976 Census figures.

the credit foncier system may present problems because of the need to reinvest principal repayments as and when they occur.

37.139 Institutional investors may not be interested in buying a pool of mortgages characterised by individual **repayments of principal**. On the other hand, savings banks and building societies are not likely to make interest-only loans unless they are reasonably assured of being able to sell the resulting mortgages. At present, they rely on the credit foncier method of repayment to ensure a stream of repayments which are then available for relending or to meet withdrawals.

37.140 The Committee believes this may prove a significant problem for many institutional investors and the further development of a SMM in Australia may require a lesser emphasis on the 'credit foncier' system.

37.141 Early repayment is an associated problem. Mortgages, whether credit foncier or interest-only, are subject to the possibility of prepayment or early redemption. This means that the purchaser is faced with the possibility of having to reinvest funds at an inauspicious time.

37.142 The Committee believes it should be possible for contracts to provide for a special cost loading in the event of prepayment or early redemption. Indeed, most fixed-rate mortgages already contain clauses regarding penalties for early redemption.

37.143 A further impediment to a broadly based SMM arises out of the **distinct characteristics** of mortgages and the properties they cover. If the price-setting function of a SMM were to be performed efficiently, it is essential that there should be standardisation of the instruments to be traded. This implies a need to eliminate differences between mortgages, whether arising from legal considerations, local peculiarities or the different views of lenders. The issue of mortgage-backed securities is one way of achieving standardised, marketable instruments even though the mortgages backing them may not be standardised.

37.144 Finally, there is the matter of the **creditworthiness of the borrower** and the fact that the purchaser of a mortgage in the SMM must always look to the property against which it is written as the ultimate security for his capital.[45] For this reason, in Australia, insured mortgages are generally preferred for trading or as backing for securities — more particularly those insured with the government-owned HLIC. This is generally the case also in the United States, where there is a market in mortgages which are insured either privately or by government agencies (see Appendix 37.2).

37.145 The role of HLIC in respect of the security for mortgages traded in the SMM is discussed later in this chapter and in Chapter 30.

37.146 An alternative way of ensuring security is through the issue of mortgage-backed securities with significant over-collateralisation (i.e. backed by a pool of mortgages with a much greater face value than that of the security). This may be seen as compromising the security of ordinary depositors, but could nevertheless be acceptable if the volume of mortgage-backed bonds issued were small in relation to a savings bank's/building society's total portfolio of mortgages.

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45 In the case of mortgage-backed securities, there is also the question of security associated with the viability of the issuer of the securities. It is understood this has been handled, to date, through the use of trustees.

(b) Government Regulation and Taxation

(i) Interest Rate Regulation

37.147 A fundamental obstacle to the development of a secondary market in the mortgages issued by the major housing finance institutions in Australia is the fact that such mortgages are usually issued at lower than market rates of interest.

37.148 Census data (1976) reveal that nearly 36% of privately financed first mortgages outstanding were originated by savings banks and a further 28% by building societies. Savings bank housing loans carry a controlled rate of interest; those of building societies are controlled in some states.[46] These rates tend to be below those on housing loans provided by other, unregulated, financial institutions.

37.149 As noted earlier, a secondary mortgage market is likely to develop only where mortgages or mortgage-backed securities yield a (risk-adjusted) return which is competitive with other forms of investment.

37.150 This is evident from overseas experience, as indicated in Figure 37.4. In both the United States and Canada, where secondary mortgage markets are quite sizeable, the rate of interest on mortgages being traded has consistently been well above the yield on government securities and above or equal to that on corporate bonds.

37.151 Higher returns than the present mortgage rates would need to be available to investors before a secondary market could be expected to develop in building society and savings bank mortgages or securities backed by these mortgages. A demand could develop, of course, for mortgages which were discounted sufficiently to ensure a market rate to investors; but it would be very difficult for housing finance institutions to meet this demand from their existing portfolio.

(ii) Stamp Duty

37.152 The impact of state stamp duties on the cost of transferring mortgages or mortgage-backed securities has been suggested as perhaps the primary impediment to the further development of a SMM.

37.153 Stamp duty may add considerably to the cost of a transaction; in these circumstances a mortgage or mortgage-backed security would require an even higher yield to be attractive to investors. This is contrasted with the situation in the United States, where there is no transfer duty or taxes.

37.154 The Committee understands that very little revenue accrues to state governments from the duty on transfer of mortgages or mortgage-backed securities, which reinforces its belief that the duty is having an inhibiting effect on the development of a SMM. A lower rate of stamp duty might well generate **additional** revenue, as well as assisting the development of a SMM.

(iii) State Building Society Legislation

37.155 The restrictions on building society asset/investment powers were outlined in the Interim Report (paragraphs 15.55–66). Their general effect is to limit the societies to initiating or buying mortgages over real estate within their

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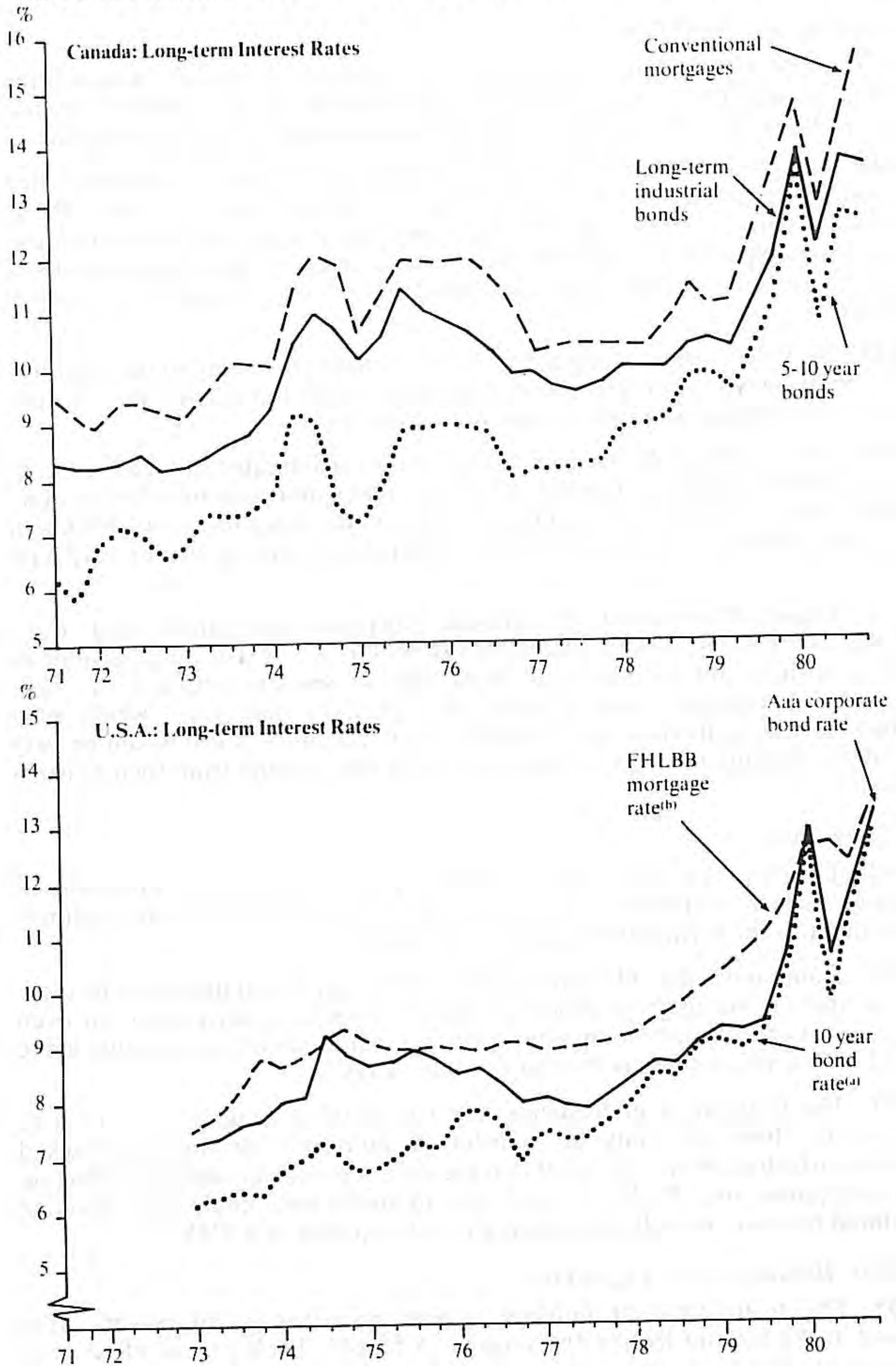
46 As well as varying with the size of the loan, rates charged by permanent building societies vary between states.

Figure 37.4: COMPARISON OF LONG-TERM INTEREST RATES: U.S.A. AND CANADA



a) Series includes 10. 12 and 15 year bonds for period Jan. 1973 to Dec. 1975

b) For period Mar. to Dec. 1973 data is for FHA new mortgage yields.

Sources: Bank of Canada Review; Chase Econometrics

state. This limits their ability to participate in a national SMM as either a buyer or a seller. As major initiators of mortgages, building societies must be given greater flexibility in this area for a national SMM to develop.

37.156 The present restrictions on interstate mobility of building society funds may significantly impair allocative efficiency: in particular, surplus housing finance in some states may not be fully available to ease housing demand pressures in other states. Removal of these restrictions, together with a secondary market in building society mortgages, might smooth such regional imbalances.[47]

37.157 As any individual state which unilaterally relaxed its restrictions could only expect to lose funds to other states, any relaxation would need to be co-ordinated, possibly by the Commonwealth.

(iv) Trustee Legislation

37.158 The Trustee Act in each state is designed to protect the beneficiaries of any trust which does not spell out the investment powers of the trustee. Generally speaking, 'trustee status' is given to first mortgages over real estate. This has not yet been extended to mortgage-backed securities, and it has been claimed that this constitutes an impediment by:

- withholding official recognition of low risk status from a security which effectively carries the same risk as securities with trustee status; and
- reducing the possible market for mortgage-backed securities.

37.159 Although their prime objective is the protection of the rights of beneficiaries, the Trustee Acts assist in providing a market for local and semi-government securities. The acceptance of market-determined rates for such securities would reduce the need for such discriminatory assistance and should facilitate extension of trustee status to mortgage-backed securities. However, the Committee appreciates that consistent prudential principles need to be applied in the selection of particular investments for purposes of trustee recognition. (This issue is taken up in Chapter 21.)

D. THE NEED FOR DIRECT GOVERNMENT INVOLVEMENT

37.160 While many submissions see the role of government as one of removing impediments to the development of a SMM, others have advocated more active involvement. It has been suggested that the Government might:

- encourage the establishment of a private secondary mortgage bank to pool, repackage and market mortgages in the form of mortgage-backed securities;
- establish a new statutory authority to trade in mortgages and/or mortgage-backed securities;
- extend the role of the Reserve Bank to include trading in mortgages and/or providing an LLR facility to a mortgage bank; or
- extend the role of the HLIC to include mortgage trading.

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47 It is recognised here (as elsewhere) that the trend towards increasing integration of the financial system should help to minimise such problems. However, the advent of a secondary mortgage market would serve to accelerate the process.

(a) Encouragement of a Private Mortgage Bank

37.161 Given the number of private operators already in the mortgage field, the only 'encouragement' to private initiative that seems to be required is the removal of certain impediments outlined earlier.

(b) Establishment of a Government-owned Mortgage Agency or Extension of the Role of the Reserve Bank

37.162 The Committee of Inquiry into Housing Costs recommended that:

> the Commonwealth should introduce a secondary (bulk) mortgage agency as a means of stabilising funds flows over time and between regions within the constraints imposed by broad monetary policy.[48]

37.163 In the view of proponents of arrangements of this kind, such an institution could ameliorate the impact of fluctuations in deposits on lending by supplementing the institutions' liquid resources nationally and regionally through either:

- acquiring existing mortgages from lenders for limited periods, and subsequently reselling them to the original lender or to other housing finance institutions; or
- making direct advances to the institutions for limited periods when their liquidity was tight.

37.164 In terms of the principles laid down in Chapter 26, the establishment of a government SMM agency would only be justified:

- on **efficiency** grounds — where it filled a market gap which would not otherwise be filled, was cost-effective and did not require government subsidisation; or
- on the grounds of **externalities**, i.e. where there were major efficiency and stability benefits over and above those directly allowed for in the calculation of private costs and returns.

37.165 The Committee does not believe there is a case for establishing a government SMM agency on efficiency grounds. The following specific considerations are relevant:

- the further development of a private commercial market might be discouraged if a government agency were established;
- such an agency would be unnecessary if interest rate controls were removed, as this could be expected to stimulate the development of a private, commercially based market; and
- any efforts to insulate housing finance institutions from the impact of monetary restraint would (with a given monetary target) increase the impact on other sectors of the economy.

37.166 Nor is it clear that there are exceptional externalities for the community at large from accelerating the development of a secondary mortgage market. The Committee does not, however, offer any firm judgments on this aspect.

37.167 If the intention of establishing an agency were merely to channel government funds into housing, the Committee believes it might well be more

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48 Recommendation 20, *The Cost of Housing*, op.cit.

cost-effective to do this through direct fiscal means. Alternative ways of channelling such assistance were discussed earlier in this chapter.

(c) Extension of HLIC's Role

37.168 Some see the HLIC's involvement in buying, holding and selling mortgages as a natural extension of its mortgage insurance role. This suggestion raises similar issues to those outlined above. For the reasons stated, the Committee does not see the need for any government instrumentality to assume the general functions of a secondary mortgage market agency.

37.169 The role of HLIC in relation to the development of a secondary mortgage market in Australia is discussed in Chapter 30.

E. CONCLUSIONS

37.170 The Committee believes that the establishment of a broadly based and active secondary mortgage market in Australia would be a useful development.

37.171 It sees some potential benefits from:

- greater integration between the housing finance and other sectors of the capital market;
- greater mobility of housing finance funds between regions of excess supply and excess demand, particularly across state boundaries; and
- greater diversity of choice for investors.

37.172 The development of an active SMM is unlikely to add substantially to the overall stability of housing finance flows, though some beneficial effects can be anticipated.

37.173 The Committee has found that the major impediments to the development of a private SMM reflect government intervention in the financial system. Consequently, it sees a need (discussed in other chapters) for certain government initiatives:

- the removal of all controls on savings bank interest rates and, where relevant, building society interest rates;
- the reduction of stamp duty on mortgage transfers, and the imposition of stamp duty uniformly among the states; and
- a regulatory framework which allows building societies to trade in mortgages on an Australia-wide basis.

37.174 In some states deposits with building societies have been granted trustee status because of their underlying residential mortgage security backing. Subject to the consistent application of prudential principles, consideration might be given to the granting of 'trustee' status to mortgage-backed securities, on the basis of their inherent security, although one would not wish to see such securities given a special privileged position in this regard.

37.175 With these impediments removed, and assuming some degree of adaptation in mortgage contracts, the Committee can see no reason why the Australian SMM should not develop as a result of private sector initiative. It does not believe there is a case for direct government intervention on efficiency grounds and therefore it does not recommend the establishment of a specialist government mortgage market agency, or an extension of the role of either the Reserve Bank or the HLIC to embrace such activities.

THE EFFECT OF INTEREST RATE CHANGES ON HOUSEHOLD SECTOR SAVINGS PATTERNS

1 In order to assess the relationship between interest rates and deposit growth, the Committee has investigated the impact on deposit flows of two recent disturbances to the structure of interest rates on household sector assets. They confirm the close relationship between interest rates and deposit growth. The episodes in question relate to:

- the period before and after Australian Savings Bonds were first issued in 1976; and
- the experience shortly before, and for the first few months after, the 'deregulation' of bank deposit rates in December 1980.

2 Australian Savings Bonds were introduced in January 1976 in order to tap household savings more effectively. The interest rates offered in the initial series, and the ability of investors to encash them at fairly short notice, made the Bonds highly competitive with the facilities offered by banks and building societies.[1]

3 Permanent building societies experienced a net deposit **outflow** over February–March 1976 of about $182 million compared with an **inflow** of about $141 million for the same period in the previous year. NSW building societies, which offered the lowest call rate (8.5%), and which did not at that time offer higher rate fixed-term accounts, were the worst affected.

4 Savings banks experienced a significant slow-down in the rate of growth of deposits over February and March 1976. The annualised percentage growth rate for the period was 8.0% compared with 10.3% for the corresponding period of the previous year, and 19.2% over the whole of the 1975 calendar year (at a time when the rate of inflation was running at about 13%.)[2]

5 In the second episode mentioned in paragraph 1 deposit-type liabilities of relevant intermediaries were also significantly affected by changing interest rate differentials.

6 Over the period September 1979–April 1981, the following changes occurred in the pattern of interest rates:

- rate increases on Certificate of Deposits (CDs) offered by the trading banks over the June quarter ('tax rundown' period) of 1980;

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1 ASB Series 1, which had a one month's notice facility, carried a coupon interest rate of 10.5% (or 8.5% for redemption during the initial months), as compared with the predominant rates of 3.75% on ordinary call ('passbook') savings bank accounts below $4000, 8% on savings bank investment accounts (which, at the time, required three months' notice of withdrawal), and a range — depending upon the state — of 8.5% to 9.5% on building society call deposits. The result was a particularly large take-up, with total subscriptions of about $760 million by the time it was replaced with Series 2 the following month.

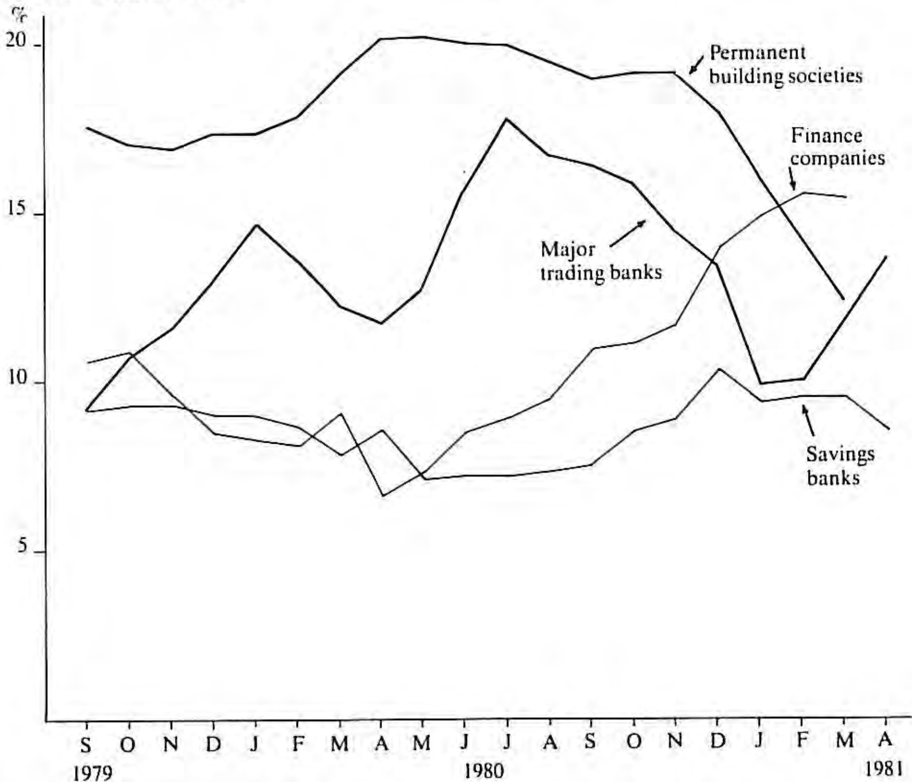
While the second series carried the lower interest rate of 9.5%, this was still at the top of the range of at-call rates offered by the savings banks and building societies (and still well above the NSW societies' rate of 8.5%). Total subscriptions were about $350 million.

2 Other evidence confirms that the short-notice Series 1 ASBs had a significant impact on the deposit growth of housing finance intermediaries. See for example, H. N. Johnston and J. R. Perrin 'The LGS Asset Portfolio Behaviour of the Non-financial Private Sector', Paper presented to Seventh Conference of Economists, August 1978.

- increases in the rate on savings bank investment accounts over the second half of 1980;
- increases in rates offered by finance companies on debentures over the 1980–81 financial year; and
- most importantly, the deregulation of all bank deposit interest rates in December 1980, reflecting principally in sharp increases in rates on trading bank fixed deposits, particularly for terms around six months. At the same time, controls on the rates which the banks were able to charge on housing loans were retained, thereby providing them with an incentive to minimise lending of this type.

7 The effects of these changes on deposit liabilities are shown in Figure 37A.1. The first of these is clearly reflected in the upturn in the trading banks deposit growth in the June quarter of 1980. Over this period the substantially unrestricted ability of the trading banks to increase yields on CDs enabled them to play a major role in meeting the seasonal demand for funds.

FIGURE 37A1: ANNUAL GROWTH RATES IN DEPOSIT-TYPE LIABILITIES (%)[a] — SAVINGS BANKS, TRADING BANKS, PERMANENT BUILDING SOCIETIES, AND FINANCE COMPANIES



a) Monthly data, expressed as a percentage change on the corresponding month of the previous year

Source: Australian Bureau of Statistics

8 The second development — the increase in savings bank investment account rates — although not so strongly reflected in Figure 37A.1, facilitated a turnaround in the decline in deposit growth of savings banks apparent from late 1979 to mid 1980.[3]

9 After the first quarter of 1980 finance companies began to compete more vigorously for funds, and their success in raising funds was largely at the expense of the trading banks, which were subject to continuing interest rate controls.

10 In December 1980, the Treasurer announced the removal of all controls on bank deposit rates. It is clear from Figure 37A.1 that the increases in interest rates on conventional trading bank fixed deposits were accompanied by a sharp turnaround in trading bank deposits growth, even allowing for the normal seasonal pattern.

11 The impact of interest rate controls or 'suasion' on permanent building societies is particularly noticeable in Figure 37A.1. In most states there have been only relatively small interest rate increases, and then sometimes only after a considerable lag, and not on call deposits. The growth of their deposits has fallen off since late 1980, a movement which is contrary to the usual seasonal pattern, resulting in substantially reduced housing finance approvals (see Figure 37.3).

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3 An important indication of the growing sensitivity of investors to interest rates is the composition of the growth in savings bank deposits. Over 1980 deposits in investment accounts increased by nearly 17%, while those in ordinary passbook accounts grew by only 4.4%.

SECONDARY MORTGAGE MARKETS OVERSEAS

1 Secondary mortgage markets exist in several overseas countries in one form or another. The best known are those in the United States. A detailed outline of the latter markets is provided in this appendix together with a brief outline of salient features of secondary mortgage markets in Canada, Denmark, Italy and France.

THE UNITED STATES SECONDARY MORTGAGE MARKET[1]

2 While an active and viable private secondary mortgage market has operated for some years in the USA, the activities of a number of federal agencies, including in particular the Federal Home Loan Bank Board, the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), have done much to develop the breadth and depth of secondary markets in mortgages and securities backed by mortgages.[2]

3 The role played by government agencies has broadly been designed to:

- improve the allocative efficiency of housing finance markets by diminishing regional imbalances in the demand for, and supply of, housing finance;
- moderate cyclical fluctuations in housing finance flows;
- increase the availability of housing finance by making mortgages and securities backed by mortgages[3] more attractive to investors; and
- subsidise the cost of housing finance to particular groups in the community.

4 However, one or two points should be noted. The need to improve the allocative efficiency of housing finance markets reflects, to a substantial degree, the existence over many years of restrictions on banks operating outside their own state, and the development, as a consequence, of a unit banking system. Similar restrictions have applied to savings and loan associations, which are broadly comparable to permanent building societies in Australia. The effect has been to impair the ability of intermediaries, through a national spread of operations, to move funds readily between capital surplus and capital deficit areas.

5 The third and fourth objectives in paragraph 3 should be viewed in the context of overall US housing programs designed to increase the availability and reduce the cost of housing finance. To a significant extent, it would seem that FNMA, GNMA and FHLMC

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1 The Committee would like to thank Ms Susan Kelsey, Director, Policy Analysis Division of the Federal Home Loan Bank Board, for her considerable assistance in respect of this discussion of the US Secondary Mortgage Markets.

2 The Farmers Home Administration, an agency within the Department of Agriculture, also plays a role in the secondary mortgage markets with respect to loans on rural properties.

3 Mortgage-backed securities usually take one of two forms: **bonds**, where a pool of mortgages provides collateral to secure repayments of principal, and **pass-through securities**, where ownership in a pool of mortgages is transferred, or passed through, to the owners of the securities who share in monthly payments of interest and principal from the pool.

have been used to achieve housing policy objectives which, in Australia, have been pursued through other means (e.g. assistance for home purchases by low income earners on concessional terms and conditions through State Housing Commissions, State banks, terminating building and co-operative housing societies).

6 In fulfilling these aims, these agencies have broadened the ultimate sources of finance for housing, with market yields and low risk encouraging a range of institutional investors to invest directly or indirectly in mortgages. They have also provided a mechanism for tapping the private sector for funds for welfare housing, with the subsidy element being provided by the Government.

7 Between 1975 and 1980, $489.4 million of mortgage-backed securities were issued by these agencies in the private market. As well, by encouraging the standardisation of mortgages and a familiarity with mortgages and mortgage-backed securities as investment media, these agencies have spurred the development of a private secondary mortgage market.

Role of Government Institutions in the Secondary Mortgage Market

Federal Home Loan Banks (FHLBs)

8 While not directly participating in the secondary mortgage market, the FHLBs are an example of the US Government's early concern with housing.

9 Established in 1932, the FHLB system is a network of twelve regional banks operating under the auspices of the Federal Home Loan Bank Board. Their objective is to assist savings and loan associations (S & Ls) and mutual savings banks in extending additional home loans or in meeting heavy withdrawals.

10 The FHLBs provide refinancing facilities to S & Ls. Advances generally are of two kinds: short-term liquidity support (up to one year) to cover exceptional withdrawals; and long-term facilities (up to ten years) for the purpose of loan expansion.

11 The resources of the FHLBs include some share subscriptions and deposits by member institutions. However, they are primarily funded by issues of long-term debentures and short-term discount notes. There is an element of government subsidisation in respect of these borrowings, by virtue of the line of credit provided by the Federal Treasury. Though this standby has never been utilised, it allows the FHLBs to issue securities at rates comparable to those of semi-government instrumentalities.

12 At the end of 1980, $49.0 billion in FHLB advances were outstanding. The Federal Home Loan Mortgage Corporation was chartered by congress in 1970 as part of the Federal Home Loan Bank Board to operate as a secondary market facility. Its activities are discussed later in this appendix.

Federal National Mortgage Association (FNMA)

13 The FNMA (commonly known as Fannie Mae) was formed by the US Government as a wholly owned government corporation in 1938 to purchase mortgages insured by the Federal Housing Administration (FHA). In 1948 it was authorised to purchase mortgages guaranteed by another government agency, the Veterans Administration (VA).[4]

14 As a secondary mortgage market facility, FNMA has several functions:

- through its borrowings it taps sources of private funds that might not otherwise be available for the financing of residential mortgages;
- by sharply increasing its purchases of mortgages during periods of credit shortage,

4 The VA and FHA only insure mortgages made on concessional terms. To qualify, mortgages must carry a fixed rate of interest lower than a ceiling set by the agencies, carry a thirty-year maturity, involve a high loan-to-valuation ratio and must not exceed a predetermined loan amount.

FNMA helps maintain the supply of finance to mortgage lenders, home buyers and home builders;

- by purchasing mortgages at yields determined at auctions, FNMA helps channel funds to areas where there is a high demand for housing: greater demand for residential mortgage funds in a particular area will be reflected in a greater willingness to sell mortgages to FNMA at a lower price and thus a higher yield;
- through its commitments for the future purchases of mortgages, FNMA assures lenders of a market for their mortgages, thereby encouraging them to commit additional funds to housing loans.

15 FNMA policies call for extensive sales of mortgages whenever there is a surplus of funds in the mortgage market and an opportunity to apply the proceeds by reinvestment or reducing its indebtedness in such a way as to recoup, over a reasonable period of time, any immediate losses occasioned by the sale. Primarily reflecting inflation, these conditions have not coincided in recent years, so that FNMA has operated as a long-term investor in mortgages (see Table 37A.1).

16 Since it was established, FNMA has undergone a number of structural and functional changes. In 1954, FNMA was rechartered as a mixed-ownership corporation, owned partly by private shareholders and partly by the US Government. Apart from the management and liquidation of its then existing portfolio, it was charged with providing special assistance (through mortgage purchases) where private mortgage finance was not ordinarily available and providing a secondary market for FHA-insured and VA-guaranteed residential loans. This function became increasingly important in the mid 1960s as the attractiveness of these loans diminished in the face of rising interest rates which were not matched by increases in the ceilings on FHA and VA loans.

17 The Housing Act of 1968 changed FNMA's status from a mixed-ownership corporation to a corporation owned by stockholders. Although privately owned, its ties with government are evident in a number of areas, e.g. five of its fifteen directors are Presidential appointees and the Department of Housing and Urban Development (HUD) retains the power to set its debt limit and may require it to allocate a portion of its total mortgage loan purchases to programs related to national housing goals.

18 In 1970, FNMA was empowered to operate a secondary mortgage market for conventional mortgages (i.e. mortgages which are privately insured). Purchases of such mortgages rapidly became a major part of FNMA's activities, and accounted for nearly 34% of all mortgages purchased by it in 1980.

19 Unlike GNMA and FHLMC, FNMA finances its operations primarily through the issue of debentures and short-term discount notes.[5] These debt instruments, though not guaranteed by the US Government, are 'agency securities', a designation that enables it to borrow at lower rates than would otherwise be the case, to the eventual benefit of mortgagors.

20 FNMA purchases mortgages by issuing 'commitments to purchase' through an auction held every two weeks. The sellers/servicers of mortgages (a group of some 2000 mortgage-initiating institutions, primarily mortgage bankers) state the volume of mortgages, and the associated yields, which they are prepared to offer. After considering the yields on the mortgage packages offered, along with money market conditions and other factors, FNMA establishes a 'cut-off yield' and issues 'commitments to purchase' mortgages the yields of which are at or above the cut-off yield; e.g. in 1980 FNMA accepted 47% of offers to sell FHA/VA mortgages and 45% of offers to sell conventional mortgages. It allows the seller/servicers a fee of three-eighths of 1% p.a. to continue the collection and payment to FNMA of interest and principal on the mortgages it purchases.

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5 FNMA has also issued a small volume of mortgage-backed bonds, which are guaranteed by GNMA, and is currently developing arrangements for the issue of securities backed by conventional mortgages.

TABLE 37A.1: FNMA – SECONDARY MORTGAGE MARKET ACTIVITY

Year ended 31 Dec.	*Mortgage purchases $m*	*Of which conventional mortgages %*	*Mortgages sales $m*	*Mortgage portfolio $m*
1955	86	–	–	86
1960	980	–	42	2 903
1965	757	–	46	2 520
1970	5 078	–	–	15 502
1971	3 574	–	336	17 791
1972	3 699	1	211	19 791
1973	6 127	15	71	24 175
1974	6 953	16	4	29 578
1975	4 263	13	2	31 824
1976	3 606	70	86	32 904
1977	4 780	49	81	34 370
1978	12 303	45	8	43 311
1979	10 679	50	22	51 097
1980	8 002	34	1	57 029

Note: All data have been adjusted to exclude special assistance and management and liquidation functions transferred to GNMA in 1968.

Source: Federal Home Loan Bank Board.

21 FNMA is the largest purchaser of residential mortgages, with purchases being predominantly from mortgage banking companies. As at December 1979, its portfolio of 1.5 million mortgages, with principal outstanding amounting to $51 billion, accounted for 5% of total residential mortgage debt outstanding.

22 As its sales over the same period were negligible (see Table 37A.1), FNMA might be best regarded as a lender with a permanent loan portfolio rather than as a secondary market agency.

Government National Mortgage Association (GNMA)

23 GNMA (commonly known as Ginnie Mae) was formed in 1968, when FNMA was floated off as a private company, to take over the government functions that had previously been undertaken by FNMA. It has two principal functions:

- to provide housing finance that the private market does not ordinarily provide (e.g. to low and moderate income households) and add to the available supply of housing finance during periods of credit tightness; and
- to guarantee securities which are issued by private mortgage institutions against pools of FHA-insured or VA-guaranteed mortgages for sale to the private sector.

24 The first (special assistance) function reflects the fact that, until quite recently, mortgages have typically carried a fixed rate of return in the USA. Thus, in periods of generally rising interest rates, existing mortgages have had to be sold at a discount in order to attract investors. This is done in two ways:

- GNMA may acquire mortgages carrying a lower-than-market yield and sell them to investors at a market rate, absorbing any difference between the prices it has paid and the prices it has received; and
- FNMA or FHLMC, acting as an agent for GNMA, may issue a commitment to private lenders to purchase conventional mortgages yielding a lower-than-market rate, provided the lower rate is made available to the borrower; GNMA again absorbs the discount so that mortgages sold by FNMA or FHLMC bear a market rate.

25 The discount is funded by borrowings from the US Treasury or from the proceeds of sales of mortgages. In fulfilling this welfare function, GNMA acts in a contra-cyclical manner in terms of monetary policy, i.e. it insulates the housing sector.

26 The second function is more directly aimed at fostering a secondary mortgage market in FHA-insured or VA-guaranteed mortgages. GNMA guarantees the payment of interest

and principal on pass-through securities issued against the backing of a pool of mortgages. These pools are formed and securities are issued by GNMA-approved private originators, of whom there are over 950. The pools must contain a minimum of $1 million of FHA and/or VA mortgages with an age of less than one year. The pass-through securities are issued in minimum denominations of $25 000. The originators retain responsibility for servicing the mortgages, arranging monthly payments to be passed through from the mortgagors to the holders of the securities.

27 Since GNMA pass-through securities were first issued in 1970, the issue of and trade in these securities have expanded markedly (see Table 37A.2). Over 90% of all newly originated FHA and VA mortgages are placed via GNMA pass-throughs or sold to FNMA. At 30 September 1980, there were $94 billion in GNMA pass-through securities outstanding. Of these about 31% were held by nominees, 16% by S & Ls, 10% by mutual savings banks, 9% by pension funds, 7% by brokers and dealers, 7% by companies and partnerships and 6% by commercial banks, with the remaining 14% being held by credit unions, individuals and others.

28 In May 1979, GNMA began to guarantee pass-through securities, backed by graduated payment mortgages (which have a lower monthly payment in the first few years than standard mortgages bearing the same coupon) and insured by the FHA.

29 GNMA also guarantees mortgage-backed bonds issued by FNMA and FHLMC. These are long-term securities providing for payment of interest semi-annually and principal at stated redemption dates. These are not, however, a major source of funds for FNMA and FHLMC.

TABLE 37A.2: GNMA — SECONDARY MORTGAGE MARKET ACTIVITY ($m)

	Pass-through securities			
Year ended 31 Dec.	*Mortgage portfolio*	*Applications received*	*Securities issued*	*Outstanding principal balances*
1970	5 222	1 126	452	5 222
1971	5 321	4 374	2 702	5 332
1972	5 111	3 854	2 662	5 504
1973	4 045	5 529	3 249	7 890
1974	4 849	6 203	4 784	11 769
1975	7 242	10 449	7 366	18 257
1976	4 407	25 394	13 765	30 572
1977	3 249	31 076	16 230	44 896
1978	2 741	35 014	15 359	54 347
1979[a]	3 181	48 464	22 019	76 401
1980[a]	4 215	63 165	22 996	93 874

(a) Data for year ended 30 September.
Source: Federal Home Loan Bank Board.

30 There has been trading in futures contracts in GNMA pass-through securities since 1975. This market enables mortgage originators to hedge future mortgage loan commitments. The need for this market reflects the fixed rates on loans: if interest rates rise while a mortgage originator is forming a pool, he will incur a capital loss.

Federal Home Loan Mortgage Corporation (FHLMC)

31 FHLMC (commonly known as Freddie Mac) was created in 1970 as a federally chartered corporate subsidiary of the Federal Home Loan Bank Board, to stimulate development of the secondary market in conventional mortgages, which account for 75% of all home mortgages.

32 FHLMC has three objectives:

- to tap new sources of funds during periods of credit stringency;
- to circulate funds from capital surplus to capital deficit areas; and

- to develop instruments to promote the private secondary market in conventional mortgages.

33 FHLMC purchases primarily new mortgages from savings and loan associations and, to a lesser extent, from mutual savings banks and commercial banks. Initially, it financed its purchases by borrowing from the Treasury and issuing debt securities. In 1974, however, FHLMC commenced issuing mortgage participation certificates (PCs), which are now its primary means of financing purchases.

34 FHLMC's PCs are similar to the pass-through securities guaranteed by GNMA in that they are backed by, and based on, pools of mortgages with the monthly principal and interest payments, including prepayments, 'passed through' to the holder of the PCs. The certificates have a minimum denomination of $25 000.

35 However, apart from the fact that pools comprise only conventional mortgages, PCs differ from GNMA pass-throughs in that they are issued by FHLMC rather than by individual mortgage lenders. As well, a pool may contain mortgages issued at different rates, facilitating the circulation of funds between different regions.

36 In 1980, $2.5 billion in participation certificates were issued, bringing the outstanding unpaid balance to $16.9 billion.

37 In 1974, the FHLMC developed guaranteed mortgage certificates (GMCs). While these also represent ownership interest in a pool of mortgages, GMCs have certain bond-like characteristics; they are intended to appeal to bond investors by providing a semi-annual payment of interest and annual repayment of principal (according to a predetermined schedule) rather than a monthly cash flow. In 1979 new issues totalled $750 million, bringing the outstanding upaid balance to $2.4 billion. There were no issues in 1980 and the outstanding principal balance decreased to $2.2 billion.

38 Because of the greater standardisation of FHA and VA mortgages, the FHLMC purchased a greater volume of these mortgages than it did conventional mortgages in the early years of its operation. (See Table 37A.3.) However, as the S & Ls and mutual savings banks issue predominantly conventional mortgages, it has done much to standardise documents and procedures used in making conventional loans.

TABLE 37A.3: FHLMC – SECONDARY MORTGAGE MARKET ACTIVITY

Year ended 31 Dec.	*Purchases $m*	*Sales $m*	*Mortgage portfolio $m*	*Of which conventional mortgages %*
1970	326	–	325	–
1971	778	113	968	15
1972	1 294	407	1 788	16
1973	1 334	409	2 604	31
1974	2 185	53	4 586	57
1975	1 715	1 021	4 987	62
1976	1 129	1 397	4 269	61
1977	4 160	4 040	3 267	56
1978	6 526	5 726	3 091	58
1979	5 721	3 794	4 052	72
1980	3 723	2 529	5 056	78

Source: Federal Home Loan Bank Board.

39 In seeking to discharge its responsibility to circulate funds from capital surplus to capital deficit areas, FHLMC has also concentrated its purchase activity in areas that have been unable to mobilise sufficient savings to meet the demand for housing finance, with PCs and GMCs being sold in areas where the demand for housing finance falls short of the potential supply.

40 It is clear from 37A.Table 4, which sets out the geographic location of the properties

underlying FHLMC's mortgage portfolio, that FHMLC has circulated funds from the eastern states (notably the Boston, New York and Pittsburgh areas) to the southern and western states (including the Los Angeles, Seattle and Atlanta areas).

TABLE 37A.4 FHLMC – GEOGRAPHIC DISTRIBUTION OF MORTGAGE PORTFOLIO[a]

	% of total mortgages		
Year ended 31 Dec.	*1978*	*1979*	*1980*
Boston	0.6	0.6	1.0
New York	1.1	1.4	1.8
Pittsburgh	1.0	0.7	0.7
Atlanta	14.3	13.6	13.8
Indianapolis	3.6	3.7	3.5
Chicago	4.9	5.1	5.1
Des Moines	2.2	1.9	1.7
Little Rock	9.6	7.9	7.2
Denver	8.8	7.8	6.8
Los Angeles	42.9	46.8	49.0
Seattle	11.0	10.5	9.4
	100.0	100.0	100.0

(a) Includes mortgages held by FHLMC (see column 3 in Table 37A.3) and mortgages which have been sold but in respect of which FHLMC has guaranteed payment of principal and interest.

Source: Federal Home Loan Mortgage Corporation, *Financial Profile*, 10 April 1981.

41 In order to carry out its role of increasing the liquidity of mortgages and lowering the cost of transactions, FHLMC in 1973 joined with major financial institutions' trade organisations to create a private computerised listing service (the Automated Mortgage Market Information Network) for mortgage loan buyers and sellers.

The Private Secondary Mortgage Market

42 A private secondary market has coexisted for years with that involving various government agencies. Mortgages and participations in pools of mortgages have long been sold to investors on a private placement basis, resulting in a channelling of funds from capital surplus to capital deficit areas. In some cases, S & Ls have been forced by their state usury laws to purchase mortgages originated in another state as an investment in order to remain competitive in deposit markets.

43 The private market has developed rapidly during the 1970s with the placement of publicly issued pass-through securities by banks, S & Ls and subsidiaries of private mortgage insurance companies.

44 S & Ls have sought to supplement funds taken by way of deposit and through the sale of mortgages to federal agencies, principally FHLMC, by the issue of pass-through securities directly to the public. These issues have been made principally to institutional investors.

45 Since 1975 S & Ls have also issued more than $1 billion in mortgage-backed bonds in their own name. These bonds usually have a fixed maturity, with interest payments being made every six months and the principal repaid at maturity.

46 Initially the bonds were collateralised by a pool of FHA and VA mortgages to ensure their marketability. However, later issues have been over-collateralised by conventional mortgages (i.e. the market value of mortgages in the pool is more than 100% of the face value of the outstanding securities), with a covenant obligating the issuer to maintain a minimum level of collateral irrespective of any decline in the market value of the mortgages. These levels are normally so high (usually 150% or more) that the bonds are highly rated.

47 Unlike pass-through securities, payments on the bonds do not depend on payments made from the underlying pool of mortgages. As the bonds are a debt obligation, payment is guaranteed by the S & Ls.

48 These bonds represent a flexible approach to financing from the S & Ls' viewpoint as they can pledge old, relatively low-yielding loans as collateral without showing capital losses on their books. They are issued with original maturities of five to ten years, in line with the average maturity of new mortgages. As well as broadening their funding base, this enables S & Ls to match more closely the maturity of their assets and liabilities.

49 There were thirty-nine public issues of mortgage-backed bonds totalling $3145 million in the six years 1975–1980 and thirty-five private placements of mortgage-backed bonds totalling $503 million.

50 In 1977 the Bank of America sold the first publicly issued pass-through securities, a development that was soon taken up by others.[6] These securities are backed by conventional mortgages and carry no form of government guarantee. The issuer forms a mortgage pool or trust, obtains private mortgage insurance and secures a rating; the securities are then sold through an underwriting group. Publicly issued pass-through securities totalling $233 million were sold in 1980, bringing the total to $1.6 billion in the period 1977 to 1980. Private placements of these securities totalled $489 million over the same period.

51 The above securities are issued by individual lenders. In an attempt to enable access to the market by small lenders, 'conduit' companies commenced issuing securities in 1979 which are serviced by thirty to forty lenders.

52 In response to the problems associated with having to pay a market rate for deposits during a period of volatile deposit rates, while traditionally making fixed interest loans, S & Ls have increasingly turned to the issue of renegotiable rate mortgages and variable rate mortgages, particularly in California, where the demand for housing finance has been particularly strong. About 7% of mortgages held by S & Ls at the end of 1980 were of these kinds, although most permitted only limited rate change flexibility.

53 A limited market in variable rate mortgage-backed certificates issued by S & Ls has developed in the second half of the 1970s. To make these certificates attractive to investors, changes in interest rates are related to a published index, which moves with the market cost of funds, so the investor always obtains a return related to current market conditions. However, the selling institutions emphasise that there is no guarantee that the VRM-backed securities will be able to be resold in the secondary market without a loss being incurred.

54 In April 1981, the Comptroller of the Currency (who regulates commercial banks) and the Federal Home Loan Bank Board issued new regulations authorising more highly flexible adjustable rate mortgages (ARMs). Lenders which issue ARMs are now permitted to utilise any interest rate index that is readily verifiable by the borrower and is beyond the control of the lender. The FHLMC has indicated that it intends encouraging the growth of a large private secondary market in ARMs by issuing commitments to purchase such mortgages.

Overview of the US Secondary Mortgage Market

55 Table 37A.5 provides a 'snapshot' of the relative importance of the different institutions making funds available for housing by participating in the secondary market. To provide some perspective, purchases of '1 to 4 family home mortgages' in 1980, at $69.3 billion, amounted to more than 50% of the increase in such mortgage debt outstanding.

56 The role of the Federal agencies, principally FNMA, GNMA AND FHLMC, is understated in this table. Sales by these agencies represent only sales of mortgages, not sales of FHLMC PCs or GMCs; nor do they include sales of GNMA mortgage-backed securities. As the agencies pool the mortgages they purchase, these are included in the data for mortgage pools.

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6 The Bank of America has played a very active role in the issue of such securities; in the four years 1977 to 1980, its public issues of such securities amounted to a total of more than $1 billion.

TABLE 37A.5: MORTGAGE PURCHASES AND SALES IN THE USA, 1980 (1 to 4 family Home Loans)

Lending groups	1 to 4 Family home mortgages			
	Purchases $m	%	Sales $m	%
Commercial banks	3 716	5.4	6 671	10.3
Mutual savings banks	996	1.4	725	1.1
Savings and Loan Associations	12 440	18.0	15 523	24.0
Mortgage companies	3 593	5.2	31 133	48.2
Mortgage pools	26 717	38.6	3 203	5.0
Federal agencies	14 381	20.7	7 226	11.2
State and local credit agencies	5 552	8.0	—	—
Other	1 909	2.7	161	0.2
Total	69 274	100.0	64 642	100.0

Source: US Department of Housing and Urban Development.

57 Tables 37A.6 and 37A.7 distinguish between the primary and secondary markets in conventional (i.e. privately insured) mortgages and FHA-insured and VA-guaranteed mortgages. The involvement of S & Ls in the secondary market in conventional mortgages should be noted; their substantial purchases **and** sales reflects the movement of funds from capital surplus to capital deficit areas (see paragraph 40).

TABLE 37A.6: CONVENTIONAL MORTGAGE LOANS ON 1 TO 4 FAMILY HOMES, AND SECONDARY MARKET TRANSACTIONS, 1980

	New loans $	%	Mortgage purchases $	%	Mortgage sales $	%	Net acquisitions $	%
Commercial banks	25 167	24.0	3 340	8.6	4 877	13.2	23 630	22.2
Mutual savings banks	5 210	5.0	713	1.8	638	1.7	5 284	5.0
S & Ls	58 319	55.7	11 785	30.5	13 314	36.0	56 790	53.4
Mortgage companies	7 711	7.4	526	1.4	7 693	20.8	544	0.5
Mortgage pools	—	—	7 051	18.2	3 203	8.7	3 848	3.6
Federal credit agencies	4 378	4.2	9 104	23.6	7 226	19.6	6 256	5.9
State and local credit agencies	2 242	2.1	4 621	12.0	—	—	6 863	6.4
Other	1 729	1.6	1 500	3.9	24	—	3 205	3.0
Total	104 756	100.0	38 640	100.0	36 975	100.0	106 420	100.0

Source: US Department of Housing and Urban Development.

TABLE 37A.7: FHA-INSURED AND VA-GUARANTEED MORTGAGE LOANS ON 1 TO 4 FAMILY HOMES AND SECONDARY MARKET TRANSACTIONS, 1980

	New loans $	%	Mortgage purchases $	%	Mortgage sales $	%	Net acquisitions $	%
Commercial banks	1 602	6.0	375	1.2	1 794	6.5	184	0.6
Mutual savings banks	225	0.9	254	0.8	87	0.3	391	1.3
S & Ls	2 776	10.4	655	2.2	2 209	8.0	1 222	4.1
Mortgage companies	21 414	80.4	3 067	10.0	23 440	84.7	1 041	3.5
Mortgage pools	—	—	19 666	64.2	—	—	19 666	66.5
Federal credit agencies	—	—	5 277	17.2	—	—	5 277	17.8
State and local credit agencies	270	1.0	931	3.1	—	—	1 201	4.1
Other	334	1.3	409	1.3	137	0.5	606	2.1
Total	26 621	100.0	30 634	100.0	27 666	100.0	29 588	100.0

Source: US Department of Housing and Urban Development.

THE CANADIAN SECONDARY MORTGAGE MARKET

58 The Canadian system parallels the 'pass-through' operations in the United States and again reflects the interest rate differential between mortgages and corporate and government securities. There are, however, some distinctive features of the Canadian market:

- mortgages are generally sold only once, i.e. they are held to maturity by the purchasing institution;
- mortgage-backed securities are quoted on stock exchanges;
- the originating institutions are basically only sellers of mortgages; and
- unlike the situation in the United States, where government agencies write mortgage insurance or sponsor the secondary market, in Canada the Government's function has been restricted to insurance.

THE DANISH SECONDARY MORTGAGE MARKET

59 In Denmark, housing finance has been provided since the middle of the nineteenth century by mortgage institutions, which take the form of borrowers' mutual associations. In return for the deposit of mortgage deeds, the mortgage institutions issue bearer bonds to a nominal value equal to the sum of the loan to be granted. The borrower must then sell the bearer bonds for what they will fetch on the stock exchange (usually negotiated through a bank). When interest rates rise the bond must be sold at a discount, effectively reducing the total loan.

60 Borrowers have banded together in mutual associations so that collectively they can give greater marketability to mortgage loans than would result if they went to the market individually.

THE ITALIAN SECONDARY MORTGAGE MARKET

61 In Italy, the system is very similar to that in Denmark, though with the bonds being issued by mortgage banks. However, the mortgage bonds have one further feature which has contributed greatly to their popularity; nearly all of them are placed with customers of the banks owning the mortgage banks. Although they can be traded on the stock exchange, stock exchange transactions are marginal.

62 This approach makes it possible for the mortgage banks to stabilise the prices of bonds at around par through limited interventions on the stock exchange via manipulation of the supply of new bonds. The system therefore provides an implicit guarantee against capital loss. Households hold around 50% of outstanding bonds; with the remainder being held by commercial banks (about 35–40%) and other financial institutions.

63 One feature common to both Italy and Denmark is the extent to which households and other elements of the non-financial private sector are drawn into housing finance, not through savings bank deposits, but through the holding of marketable bonds.

THE FRENCH SECONDARY MORTGAGE MARKET

64 The French *'marche hypothecaire'* (mobilisation market) is the most highly developed market of the 'Bill Issue' type. In such markets mortgages are not traded; bills are issued directly by the writers of mortgage agreements secured by their mortgage portfolio.

65 There are two fundamental differences from pass through markets:

- bills are of shorter term than 'pass-through' securities; and

- because the bill issuer is a housing finance institution with a substantial mortgage portfolio (unlike pass-through institutions), it can intervene in the secondary market to influence prices.

66 The primary aim of the *'marche hypothecaire'* is to offset short-term fluctuations in funds inflows.

67 By its very nature it is closely linked to the money market. The fact that the banks, which are the principal money market operators, distribute 70% of eligible mortgages, financing two-thirds from their own funds and covering the remaining one-third of their requirements on the *'marche hypothecaire'*, creates an important link between the two markets. This ensures that *'marche hypothecaire'* rates move in line with money market rates, so that a coherent structure of rates according to maturities is created.

68 Close ties with the money markets have, however, exposed housing financiers at times to a substantial degree of short-term interest rate volatility.

CHAPTER 38: SMALL BUSINESS FINANCE

A. ISSUES

38.1 The Committee has received a number of submissions drawing attention to what are seen as inadequacies in the flow of finance to small business. It is claimed that:

- Banks and other lending institutions are unduly cautious and conservative in their assessment of the risk attached to small business projects and in the requirements they impose.
- In particular, they are often reluctant to provide debt finance to small businesses which are unable to offer suitable and sufficient collateral and which can only point to a brief period of successful operations. Where loans are made available, 'excess' security is often demanded which in turn limits the capacity of the business to raise additional funds in the future.
- The major financial institutions lack the necessary technical expertise or inclination to assess the prospects of small firms — particularly innovative firms and those at the establishment or development stage.
- Many small businesses do not qualify for an overdraft under $100 000 at concessional interest rates, yet have risk characteristics justifying lower interest rates than those charged by finance companies and other higher cost intermediaries; the ceiling on overdraft rates is consequently seen as creating a 'credit gap' in the market for such businesses.
- Long-term debt funds at fixed interest rates are difficult to obtain.
- Despite recent relaxation of its charter to enable it to lend to all kinds of business, the Commonwealth Development Bank is still unduly restrictive in its lending policies.
- The loan services and facilities available to small business, including those of the Commonwealth Development Bank, are not sufficiently well known or understood.
- There are limited market facilities for the sale of equity shares in small business, compared with the facilities available for large businesses which tend to be listed public companies.
- There are very few institutional sources to which newly established and innovative small businesses seeking venture capital and innovation finance can turn.

38.2 As well, the Treasurer has drawn the Committee's attention to certain recommendations on small business finance made by the Crawford Study Group[1] and by the Myers Committee:[2]

1 *Study Group on Structural Adjustment, Report*, AGPS, Canberra, 1979, p. 7.58 and Section 7.10.
2 *Technological Change in Australia*, Report of the Commitee of Inquiry into Technological Change in Australia, AGPS, Canberra, 1980, Recommendation 22, p. 192.

(i) The Crawford Study Group recommended that:

- the provision of contributory loan insurance on concessional terms be investigated as a means of promoting innovation, productivity and adjustment;
- consideration be given to the establishment of a specialist institution in the private sector to increase the availability of equity and long-term finance for small and medium-sized firms and/or suitable modifications to the Commonwealth Development Bank for that purpose.

(ii) The Myers Committee recommended that the Government sponsor the establishment of a private Venture Capital Corporation to provide risk capital to individuals and to small and medium-sized enterprises to facilitate the production and marketing of promising inventions and innovations.

38.3 Submissions have referred to instances overseas where governments have intervened to help small businesses gain better access to equity and loan finance in the capital markets. Appendix 38.1 discusses some of the measures taken in the United States, Canada and the United Kingdom.

38.4 In approaching its task, the Committee has had to ask itself the following questions:

- Is the provision of finance to small businesses deficient, in the sense that some small businesses are being denied funds even though the return they can make is above that available on alternative investments?
- Do these deficiencies reflect in-built market imperfections and rigidities which impair the allocative role of the financial system?
- If these inadequacies do exist, can they be removed or reduced at a cost and in a manner acceptable to the community?
- What is the most cost-effective form of government intervention to remedy these market deficiencies?

38.5 In addressing itself to these questions of efficiency in financial markets, the Committee is concerned only with those forms of bias specifically disadvantaging small businesses vis-a-vis other businesses. It has not assessed such factors as rising wage costs, inflation, slow economic growth, general monetary instability and other economic conditions which tend to affect all sectors of the economy. Nor has the Committee delved into the complex issues arising from structural adjustments within the economy which do not have special implications for the financial system; these have already been widely discussed in other reports and papers.[3]

38.6 The Committee in no way suggests that general economic conditions impact equally in all respects on small and large business, nor that these effects are unimportant for small businesses; it points out however, that their alleviation primarily rests with overall economic policies and not with policies specifically directed at small businesses. To a large extent, solutions to these issues lie outside the financial system.

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3 See for example: *White Paper on Manufacturing Industry*, AGPS, Canberra, 1977; *Some Issues in Structural Adjustment*, Industries Assistance Commission, September 1977; *Crawford Report*, op.cit.; *Flexibility, Economic Change and Growth*, Treasury Economic Paper No. 3: Treasury Submission to the Study Group on Structural Adjustment, AGPS, Canberra, 1978; *Implications of the Commission's Approach to the Development of Industries*, Industries Assistance Commission, June 1975.

38.7 Equally, the Committee accepts that the particular techniques of monetary restraint employed over the past decade or so may have impacted disproportionately on small businesses, because of their dependence on bank credit. As will be argued later, direct controls on bank lending may have made it more difficult for small businesses to obtain funds from such intermediaries. However, greater reliance by the monetary authorities on open market operations, as recommended in Chapter 4, would help to spread the burden of monetary policy more evenly throughout the financial system.

38.8 Before turning to examine closely various instances of alleged market failure, the Committee notes that a number of submissions have also called for increased government intervention in respect of small business finance because of perceived social and economic benefits that small businesses are said to generate for the community as a whole. Some of the arguments used are as follows:

(i) Small businesses help to strengthen free enterprise and democracy. Small business is the practical expression of a large section of the community's desire to be free and independent, to be 'one's own boss'.

(ii) The small business sector produces public economic benefits not adequately reflected in the private benefits (including profits) accruing to the small businesses themselves. For example:

- small businesses are seen as the natural 'seedbed' of innovation — germinating new industries, new talents and the large vigorous companies of the future; and
- because of the greater labour intensity of their operations, small businesses have a disproportionately greater potential for creating and maintaining jobs.

TABLE 38.1: SMALL FIRMS WHICH WERE OFFERED FINANCE FOR GROWTH BETWEEN JUNE 1976 AND JUNE 1978, CLASSIFIED BY SOURCE OF FINANCE

Source of finance[a]	*Firms offered finance from each source as a percentage of all firms which obtained at least part of the finance sought* [b]	
	Manufacturing (%)	*Non-manufacturing (%)*
Trading banks	54.6	53.8
Finance (including hire purchase) company	26.9	33.0
Existing shareholders/partners	35.0	31.0
Commonwealth Development Bank[c]	9.6	2.5
Personal loan (from a *person* not associated with the firm)	6.5	10.5
Trade customers and/or trade suppliers	5.0	5.0
Solicitor and/or accountant	3.2	4.3
Assurance society and/or superannuation fund	5.1	4.8
Savings bank and/or building society	2.8	3.1
New partners/shareholders (including institutional partners/ shareholders)	3.2	4.0
Stockbroker and/or merchant bank	2.5	1.0
A government department or agency	3.6	0.5
Other	4.3	3.7

(a) Some institutions have been combined because of the low number of responses relating to one or both sources.
(b) Totals add up to over 100% as many small firms received offers of funds from more than one source of finance.
(c) Not all non-manufacturing activities were eligible for CDB finance during the period covered by the survey.

Source: Bureau of Industry Economics, Research Report 10, *Finance for Small Business Growth and Development*, AGPS, Canberra, 1981.

38.9 As well, it has been argued that the Australian economy may not be of sufficient size to enable specialist private sector institutional lenders or investors to achieve an adequate spread of small business risks. This has been seen by some as justifying, at least, **interim** government assistance to a specialist small business financier on 'infant industry' grounds.

38.10 The extent to which governments, on the basis of social or wider economic considerations, wish to provide official support to small business beyond that justified on efficiency grounds is a matter on which the Committee can only make limited judgments. Nevertheless, even in that situation, it is valid for the Committee to consider which method of assistance has the least distorting effects on the functioning of the financial system.

38.11 The various issues bearing on small business finance are dealt with under the following headings:

- loan finance;
- equity finance;
- venture capital and finance for innovation; and
- financial management and information.

B. LOAN FINANCE

(a) Present Sources

(i) Trading Banks

38.12 A small business proprietor seeking external finance is likely to approach his bank as the first point of contact. Trading banks are presently the largest single source of loan finance for small businesses in Australia (see Table 38.1). Bank facilities (overdraft and term loans) are widely used by small businesses to assist in the purchase of fixed assets in addition to financing stocks and working capital.

38.13 Small businesses see particular advantages in the use of bank overdrafts:

- They offer great flexibility in usage and interest is paid only on funds actually drawn (although an unused facility fee may be charged). In practice, advances commonly run on and, in effect, become medium to long-term finance and are regarded by the borrower as a permanent component of the 'capital' of the business.
- The interest rate ceiling on overdrafts under $100 000 has been significantly below the rate charged by other institutions (and indeed by banks for loans for greater amounts).

38.14 Because of the heavy dependence of small businesses on trading bank finance, particularly overdrafts, it is not surprising that it has tended to be a focal point of grievance on their part. In particular, it is suggested that trading banks have been:

- unduly cautious in their assessment of risk;
- excessively demanding in respect of collateral, personal guarantees and the like;
- notably unforthcoming in the granting of long-term and fixed-interest finance; and

- discriminatory against small business when allocating available funds in times of monetary restraint.

38.15 The banks have expressed concern about the impression in some small business quarters that they lend solely on collateral without any regard to prospective cash flows.

38.16 Collateral requirements are seen by the banks as a useful supplement to other assessment criteria and a pragmatic yardstick; they point out that:

- Because of the interest rate ceiling on small overdrafts, trading banks are unable to charge a full commercial interest rate on small business loans and have to resort to non-price rationing in their disbursement of funds to small businesses, including rationing based on collateral; this inevitably means that some proposals are rejected.
- Economies may be obtained by using a pragmatic loan rationing procedure such as a collateral rule. Not only are some search costs avoided but banks also make savings on technical staff and can process proposals more speedily.

38.17 The Committee accepts that the availability of collateral is not necessarily a good indication of the viability of a business or the quality of management. However, given the nature of small businesses, a collateral requirement may, on balance, prove to be a useful processing procedure (particularly in cases of overdraft lending) for expediting loan assessment for the **run-of-the-mill small business.**[4] It is also consistent with the low-risk standing of banks and their responsibilities to depositors and shareholders. It is possible, nevertheless, that as a consequence of interest rate controls, the banks have at times placed excessive emphasis on collateral as a 'rationing' device.

38.18 A number of incorporated small businesses have expressed concern that the practice by banks of requiring, in some cases, personal guarantees as collateral erodes the limited liability advantage of incorporation.

38.19 There can be little doubt, however, that some incorporated small businesses, particularly those where the 'proprietor's' personal assets and the company's assets are closely interrelated, are not greatly different in character from a partnership or sole proprietorship. In such cases, unless the company has adequate collateral of its own, a trading bank may well be justified in not providing a loan (at its risk) unless a personal guarantee is forthcoming as an assurance of the 'proprietor's' confidence in and commitment to his enterprise. Indeed, it is the Committee's impression that most private companies accept the necessity of providing personal or directors' guarantees.

38.20 As regards long-term and fixed-interest finance, banks point out that:

- the four-year deposit maturity restriction constrains their ability to lend long;
- the variability, especially more recently, in the cost of deposits is not conducive to fixed-interest loans;
- large and small businesses are both affected by these elements; and
- they are encouraged to place greater emphasis on shorter repayment periods to increase the turnover of funds and hence their lending activity.

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4 It should also be noted that it is not only small businesses which have to provide collateral for loans.

38.21 Banks also point out that to the extent, if any, that compliance with monetary restraint discriminates against small business this is more a by-product of the ceiling on interest rates on overdrafts under $100 000.

38.22 The Committee is of the opinion that the interest rate ceiling on overdrafts under $100 000 has had the effect of limiting the potential access of small business to bank finance. Once the concessional element has disappeared (as recommended by the Commitee), banks should have greater incentive to make loans to small businesses since they will be able to charge interest rates commensurate with the risks involved. As well, removal of the four-year maturity restriction on deposits would increase the ability of the banks to make longer term loans — although any such loans may not be at fixed-interest rates given the likely 'mix' of the funding sources.

(ii) Finance Companies

38.23 Small businesses generally use finance companies to supplement bank finance, and as a readily available source of lease and hire-purchase finance. The Committee is satisfied that the terms and conditions of such finance are for the most part competitive and flexible. Although collateral for finance is usually required, it is normally tied to the equipment or stock being funded rather than constituting a floating charge over all of the assets of the business. The eventual arrangement reflects the 'nature of the financing' being done and the business relationship between financier and customer.

(iii) Commonwealth Development Bank

38.24 In the present regulated environment, the Commonwealth Development Bank (CDB) is an important institutional source of finance to small business. As explained more fully in Chapter 28, it was established by the Commonwealth Government to provide medium to long-term finance for specified purposes. These particularly include primary production and the establishment or development of small undertakings in cases where the provision of such finance is considered desirable by the CDB but would not otherwise be forthcoming on 'reasonable' terms and conditions. In practice this has meant that a prospective borrower must have been refused a loan of the same amount and for the same purposes from his own bank. Furthermore, the charter requires that, in determining whether or not finance shall be provided for a person, the CDB have regard primarily to the enterprise's prospects and not necessarily to the value of the security available.

38.25 The CDB's charter was extended in mid 1978 to enable it to lend to all kinds of business; previously it had been restricted from lending in areas such as wholesaling, retailing and the tertiary sector generally. As a result of the change and the reduced demand for rural CDB loans following the advent of PIBA, there has been a significant increase in the Bank's lending activity to small businesses. In the 1980–81 financial year such loans amounted to $32.4 million, which was 115% higher than three years earlier.

38.26 There are complaints, however, that in the area of loan finance the CDB:

- is nevertheless too collateral-conscious and has insufficient regard for prospects of success; and
- does not provide working capital.

38.27 The Committee understands that while collateral is not the prime consideration in assessing a loan application, the Bank, as a matter of responsible administration, seeks to obtain a reasonable measure of security. It is usual, however, for a borrower's security arrangements with his trading bank to be left undisturbed and for the CDB to lend against second or subsequent charges.

38.28 The CDB at present pursues a policy of charging interest rates for its term loans at or slightly below standard trading bank overdraft rates. Like any lending institution, the role of the CDB in providing finance is ultimately limited by the volume of funds available. Faced with demand in excess of available funds (at the rates charged), it is not surprising that the CDB should require security and lend only to the more 'creditworthy' customers.

38.29 The Bank would, no doubt, be encouraged to adopt a more flexible stance in regard to collateral if the interest rates charged on CDB loans were more closely related to the risks and prospective returns involved. This is particularly important now that, for practical purposes, the CDB can only increase its funds base by borrowing on the open market at commercial rates of interest.[5]

38.30 The CDB has informed the Committee that it is prepared to consider requests for basic working capital in the establishment or planned development of a business, particularly when the project cannot otherwise proceed and there are special circumstances preventing the required funds being obtained elsewhere.

38.31 As a general rule, however, it does not provide day-to-day working capital for established business. It regards this as more appropriately the function of commercial lenders such as the trading banks.

38.32 The Committee is conscious that if the CDB were to extend lending activity to normal working capital, it would either require additional resources or its role in the provision of medium to long-term finance would have to be reduced.

38.33 Moreover, the CDB has evolved operating practices and skills which are more in keeping with longer term lending and its greatest contribution has been in that area. However, for reasons discussed in Chapter 28, the Committee believes that in time the role of the CDB as a small business specialist commercial financier will decline, and its *raison d'etre* will disappear, if the Committee's program of deregulation were implemented.

(iv) Other Long-term Finance

38.34 It has been put to the Committee that sources of long-term loan finance for small businesses are limited. Comment has also been made that:

- unlike public companies, private companies and unincorporated enterprises do not have access to the public market for debentures;
- the larger life offices, a major source of long-term capital, do not usually lend to small businesses; and
- where long-term finance is offered, it is normally available only for the purchase of real estate and buildings, and the interest rate is usually variable rather than fixed.

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5 Prior to 1976 the CDB had relied largely on capital subscribed by the Government, retained earnings and borrowings from the Commonwealth Savings Bank. There has been no additional capital provided since 1964. Since 1971, it has been the policy of the Commonwealth Banking Corporation Board to discourage the financing of the CDB through borrowings from the other 'family' banks.

38.35 The life offices have indicated that, in general, the relatively high risk and administrative costs of small loans preclude them from responsibly taking a significant role in small business finance.

38.36 It is possible that some factors from within the financial system may have had the effect of restricting the availability of long-term finance to small business; these include the high level of concentration of long-term financial business among a few pension funds and life offices; restrictions on issues of debt securities to the public; and the apparent insufficient awareness by many small businesses of the nature and sources of debt finance available. However, in the Committee's opinion the main sources of the problems lie elsewhere and include:

- the intrinsically higher cost of smaller scale financing;
- interest rate and maturity controls on trading banks; and
- the effects of the uncertain inflationary environment on the supply of long-term, fixed-interest finance.

38.37 The interest rate and maturity constraints on trading banks are a particular deterrent to long-term lending (see section (i) above).

(b) Potential New Sources

38.38 Various suggestions have been put to the Committee for channelling more finance to small businesses. These involve:

- provision of a government loan guarantee/insurance scheme for finance provided by existing institutions;
- government sponsorship of a new institution with a special responsibility to provide long-term loan finance to small businesses; and
- expansion of the CDB's role in small business finance.

(i) Loan Guarantee/Insurance Scheme

38.39 Loan guarantee/insurance schemes have been advocated as a means of alleviating financing difficulties of business, especially small business. They allow banks and financial institutions to increase their lending to businesses with apparently viable projects but lacking proven track records or sufficient collateral. They also facilitate the provision of long-term loan finance, which is inherently riskier.

38.40 In principle, a loan insurance facility is expected to provide a basis for lenders to assess those business proposals lacking collateral backing on a more equal footing with those proposals providing collateral backing.

38.41 The basic appeal of schemes of this kind for small business finance is that they potentially allow a 'pooling' and spreading of the risk of default over the total small business population — thus limiting the risk exposure of individual lending institutions. In place of collateral, the borrower would pay a premium. Under a fully self-supporting scheme, the aggregate premiums collected would be set to cover both the administrative expenses and the losses on defaulted loans pertaining to the scheme. Successful small businesses would be effectively underwriting loans to the unsuccesful.

38.42 The Crawford Study Group[6] in its recommendation for a loan insurance scheme (for business in general) in Australia concluded that if it were operated

6 Crawford Report, op.cit, pp. 7.56–7.

commercially — i.e. if the insurance premium were set to cover the full risk of losses — the total cost of loans (insurance premium plus interest rate) would be prohibitive to many borrowers. The Study Group went on to suggest that any such scheme would have to be subsidised by government.

38.43 Leaving aside certain administrative differences, a **government-subsidised** loan insurance scheme would be similar in principle to offering a government guarantee on loans to approved borrowers. It would operate to reduce the risks that banks and other financial institutions normally face. However, the main effect would be to shift part or all of the lender's risk from private lending institutions to the Government.

38.44 The Committee viewed the Crawford Study Group's recommendation as a proposal to provide sectoral assistance to small businesses which would otherwise be unable to obtain debt finance because of:

- inadequate collateral; and/or
- high risk characteristics of the business.

38.45 Viewed from the standpoint of the efficiency of the financial system, a **government-subsidised** insurance or loan guarantee scheme for small businesses is not the most appropriate basis for providing subsidies to the small business sector[7] for the following reasons:

- loan insurance or guarantees would have the effect of diverting a proportion of available finance from customers who do not need a guarantee to those who do — which would be neither equitable nor conducive to allocative efficiency (unless it was designed to correct an existing 'bias' in the system);
- as a related point, loan guarantees may cause funds to be diverted towards high risk areas of small business activity when they could have been used more efficiently elsewhere (including other areas of small business);
- even if the **rate** of loss under either arrangement were to prove quite modest, the **overall** cost could be substantial because of the broad-based nature and administrative complexity of the scheme; and
- extensive use of loan insurance or guarantee facilities by small business could lead to over-gearing and further increase risk, and delay desirable adjustments to capital structures.

38.46 These criticisms apply to a subsidised loan guarantee or insurance scheme. If it were possible to operate such a scheme on a **commercial** basis (i.e. without any subsidisation) then, consistent with the principles outlined in Chapter 26, the Committee would still see no role for government. It should be left to the market to fill the gap.

38.47 In respect of those small business borrowers whose finance-raising capacity will still be constrained by lack of asset security even in a freer market environment, the Committee sees the basic problem to be one of insufficient equity, namely an inadequate capital base. This issue is discussed later.

(ii) New Specialist Financing Institution

38.48 Various submissions and the Crawford Report have recommended that the Government initiate the establishment of a new financial institution with a special

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7 This is despite the possibility of cost savings from a centralised risk-pooling operation.

responsibility to provide long-term loans (as well as some equity and venture finance) to small businesses.

38.49 A similar proposal has recently been made by the Small Business Advisory Council.[8] The Council envisaged that such a specialist institution would be essentially privately owned, but **it saw the need for some government support and encouragement in the establishment stages.**

38.50 The Committee is not convinced that it would be desirable for the **government** to provide direct financial support towards the establishment of a specialist small business institution for the following reasons;

- if it were basically commercially oriented, such an institution would be unlikely to be substantially different in its lending behaviour to existing commercial institutions;
- if government support were required, the proposal would be open to similar kinds of criticisms as the loan guarantee/insurance scheme (see paragraph 38.45); and
- a new institution would not be needed for this purpose as suitable arrangements for any intended government subsidy could be made through commercial financiers.

38.51 Similarly, in a climate of overall monetary restraint, a policy of encouraging banks and other financiers to channel their lending operations through a new institution may not significantly increase the overall volume of lending to small businesses; it may only alter the medium through which such loans were provided.

38.52 It is the Committee's view that its proposals in this Report for removing interest rate and other controls and generally promoting greater competitiveness will enable the financial system to be more innovative and responsive to viable financial demands; this could well include the further development by the commercial market of specialist instrumentalities or arms for lending to small business as and when this becomes commercially feasible.

(iii) Expansion of CDB's Lending Base

38.53 Nevertheless, the responsiveness of the system to small business debt financing needs may be slow, especially in the transition towards deregulation. If this were to be the case, the Government may wish to supplement, at least for a time, market facilities. It may also wish, on social grounds, to cushion the effects of deregulation on interest rates.

38.54 If the main concern were to reduce the cost of finance, this could be done through budgetary grants to ultimate borrowers. (The question of equity finance is discussed later.) The best provision of any subsidy through budgetary grants would be clearly visible to both small business and the community; this feature would ensure that government involvement in small business finance was pursued in the manner least disturbing to the normal workings of the financial markets.

38.55 If the main concern were the volume rather than the cost of loan funds,

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8 *Finance for Small Business*, a report by the Small Business Advisory Council, AGPS, Canberra, 1980, pp. 92–7.

relief could be provided (during the transition period) by easing present constraints on the CDB's capacity to borrow in the market.[9]

38.56 Certain disciplines, however, would be needed:

- the interest rates charged by the CDB should not be concessional and should make proper allowance for the risk involved, as well as for the higher costs of lending to small businesses;
- the CDB should be required to make the 'fullest' use of public borrowings as a source of funds. This would ensure that unnecessary departures from commercial criteria would be minimised in their loan assessments.

38.57 It would be hoped that in the short to medium term, and given more competitive financial markets and the disciplines whereunder the CDB would operate, commercial operators would fully expand into the activities undertaken by the CDB. If that were the case, the Committee (as proposed in Chapter 28) would see the CDB's activities ultimately being absorbed and rationalised within the CTB.

C. EQUITY FINANCE

38.58 Fundamental to the question of commercial operators lending to small business is the matter of adequate equity — an ingredient often lacking in the financial structure of such businesses.

38.59 The Committee's judgment that many small businesses often need additional equity capital rather than loan finance makes the examination of the adequacy of equity arrangements for small business particularly important, especially when it is also borne in mind that **an improved ability to raise equity capital would enlarge the small business's capacity to obtain loan finance.**

(a) Present Sources

38.60 Once established, the equity base of a small business can be augmented **internally** through retained earnings or **externally** through raising additional capital from outside sources.

(i) Internal Financing

38.61 A number of factors can affect the flow of retained earnings, including the profitability structure of the business and management policies in respect of retention. Taxation also has an important bearing on the amount of after-tax earnings available for retention.

38.62 Claims have been made to the Committee that Division 7 tax arrangements have constrained the ability of small businesses to retain earnings and hence their capacity to finance growth by internal funding.

38.63 However, many of the submissions were written prior to the 1979–80 changes in Division 7 provisions which increased the retention allowance to 70% of after-tax trading profits. In principle, the present Division 7 seeks to do no more than ensure that the amount of tax paid by the 'proprietors' of a private company corresponds as closely as possible to that which would be payable on the same

9 As noted in Chapter 28, the CDB's borrowing activity is subject to approval from the Treasurer, clearance from the Reserve Bank and the requirements of the Australian Loan Council.

income were it derived from an unincorporated enterprise. Thus Divison 7 can be seen as no more an obstacle to obtaining funds for expansion than the tax payable by proprietors on the income of an unincorporated enterprise. This issue is discussed more fully in Chapter 14.

(ii) External Equity Financing

38.64 While many small businesses are reluctant to seek additional equity capital from the public at large, there are nevertheless some willing to accept outside equity funds — particularly at the establishment stage. Because of the additional considerations involved, the questions of venture capital and finance for innovation are deferred until later in this chapter. The focus for the moment is on **established** businesses seeking additional equity finance to fund expansion.

38.65 Unlike public corporations, private companies are prohibited under the companies legislation from soliciting equity and loan funds from the 'public'. Small businesses are of course not precluded from the option of setting up and carrying on their business as public companies.

38.66 The stock market provides the normal medium for the offering of a public company's equities to the general public. However, raising capital by selling equity through the stock exchange or otherwise is only a feasible proposition for the largest of small businesses or for those whose record and growth prospects have been notable. There are a number of reasons for this:

- substantial costs are involved in making a public issue and these are relatively greater for smaller businesses seeking to raise fairly modest sums;
- many small businesses are likely to be deterred by their limited financial sophistication from seeking funds by way of equity listings;
- for prospective investors, particularly individuals, assessment of the risk and return from an investment in a small business may be difficult; even institutional fund managers are unlikely to possess sufficient detailed knowledge of the operational circumstances and locality in which a small business operates to appraise it adequately and the process of acquiring such knowledge can be costly; and
- the limited secondary market for small business equities serves to reduce their attraction for investors.

38.67 In the face of these difficulties, small businesses have traditionally relied primarily on private sources for their equity needs, and in particular on a circle of existing shareholders, family members and close friends. Small businesses point out that, given that stock exchange listing is not often viable, there are practically no other formal broking or institutional facilities available beyond this circle for bringing together potential investors and small business entrepreneurs.

38.68 In this regard the Committee notes that some years back a small number of financial corporations were established to supply equity finance to small businesses; they were mainly interested in financing established private companies with a good profit potential to the point where they became public listed companies. Indifferent results and the subsequent decline in share market values have brought about a situation where there are now only two financial corporations remaining in the area. A revival in the share market may encourage renewed commercial interest.

38.69 While small businesses find it harder than large businesses to obtain equity finance, it may be misleading to describe this as constituting a bias against small businesses or evidence of imperfections in the supply of equity finance. In the Committee's view most of these perceived difficulties simply reflect the economic fact of the higher cost of investing in small amounts and the higher risk of investing in small businesses, especially if the scope for effective spreading of the risks were limited. These difficulties are compounded by a reluctance of existing proprietors of small businesses to dilute their effective control of the enterprise.

(b) Potential New Sources

38.70 Various proposals have been made to increase the flow of equity finance to small business. These include:

- expanding the role of the CDB to provide equity finance;
- developing an 'over-the-counter market' for the unlisted shares of small public companies; and
- establishing of small business investment companies to intermediate between potential equity investors and small businesses.

(i) Expansion of CDB's Role

38.71 The Crawford Study Group has recommended that the CDB's activities be extended to provide either equity finance or packages of equity and debt to small businesses.[10] The Group argued that the CDB's close relationship with the banking system and its experience in evaluating proposals for small businesses make it the ideal candidate for a broader role in the area of small business finance.

38.72 Although there is a question as to whether the CDB has the legal power under its present charter to provide equity capital, there is no reason to believe that it would lack (or at least could not obtain) the necessary technical and financial skill to perform that function. The Committee does not, however, favour the proposed extension of the CDB's role into equity funding and draws attention to the following reservations:

- it might well have the effect of discouraging the further development of equity financing facilities within the commercial sector;
- unless CDB's funds and administrative resources were expanded, the provision of equity to small business would reduce CDB's capacity to lend in this area;
- many small businesses and financial institutions have expressed concern at the prospect of the 'government' as a shareholder;
- government employees (even those with extensive commercial experience) could not normally be expected to make better equity investment judgments (nor provide better management counselling) than commercial investors risking their own capital; and
- because of the CDB's association with the Commonwealth Bank, an extension of its operations into substantial equity financing could potentially be perceived to disturb the existing competitive balance between the trading banks.

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10 Crawford Report, op.cit, pp. 7.49–52.

(ii) Over-the-counter and Unlisted Securities Markets

38.73 Small public companies can offer their securities to the general public without actually seeking a listing on the stock exchange. However, there are at present no formal markets for transacting unlisted shares although there does exist, on a very limited scale, some matching, by business brokers and others, of buyers and sellers of existing (and proposed new issues of) unlisted shares of public companies. Small businesses often prefer unlisted trading because it avoids the publicity and reporting requirements that listing entails and, unlike a listed company, often allows the existing proprietors greater scope to retain the majority of equity in the business, and hence control.

38.74 It has been suggested that a formalisation of the market facilities for dealing in unlisted shares could improve the liquidity of such shares; it is thought that an 'over-the-counter' (OTC) type market would be more visible and accessible to potential investors.

38.75 The Committee can see potential attractions in this proposal, but it is uncertain whether such a market would be viable in Australia at least for some time.

38.76 Any move to convert an informal market into a formal one would require the introduction of some prudential rules for the protection of investors. Such rules are not necessary under the present informal arrangements because transactions are clearly conducted on a *caveat emptor* basis; there is particularly the question that the benefits may not exceed the costs.

38.77 The Committee recognises that countries which have a more formalised market in unlisted shares — the United States and the United Kingdom, for example — have more sophisticated and deeper equity markets than Australia.

38.78 The Committee has been informed that despite the size and sophistication of the equity markets in the United Kingdom, only some twenty-five unlisted companies are dealt in on the London Stock Exchange while another fourteen are dealt in by a licensed dealer (M. J. H. Nightingale & Co.) outside the Stock Exchange.

38.79 Unlisted shares must fulfil the following basic requirements before they can be traded on the London Stock Exchange:

- there must be full disclosure on the part of the company;
- at least 15% of shares must be in the hands of the public; and
- the company must be in business for at least three years.

38.80 No firm indication has been given of an earnings or asset size requirement for participation in the London Stock Exchange's proposal.

38.81 However, by way of comparison, Nightingale & Co. is presently only interested in companies with annual pre-tax profits of not less than the equivalent of approximately $A700 000.

38.82 For the initial public offering, Nightingale & Co. charges commission at the rate of 2.5% (plus value added tax (VAT)) of the gross amount of the equity securities sold and for the secondary trading it imposes an annual fee of approximately $A10 000, together with a commission of 1.5% (plus VAT) of the gross amount of securities traded.

38.83 In view of the likely transactions costs involved and the disclosure requirements needed to maintain an appropriate degree of investor confidence in such a market, the Committee believes that, on present indications, the potential unlisted companies market would be too thin to support a formal viable OTC market in the securities of unlisted small public companies in Australia; it is unlikely that brokers would be willing to deal with more than a handful of selected larger small businesses.

38.84 The costs could, of course, be reduced if the disclosure requirements for participating companies were reduced. The Committee could not recommend such a relaxation if there were any danger it might encourage entry into the market of undesirable participants and expose the investing public to unwarranted risks. It is essential that financial schemes of an experimental character be launched on a prudent footing to foster investor confidence and involvement. At the same time, the OTC could be marketed as a more 'speculative' equity medium to attract a particular clientele and this might permit some relaxation of reporting and other requirements, but it would not be prudent in the longer term to move too far in that direction.

38.85 The viability of an OTC market must be allowed to be determined by commercial forces and the Committee, accordingly, does not favour any formal action by the Government to promote such a market. It is hoped, however, that commercial interests, and perhaps the stock exchanges, will take initiatives in this area as soon as it becomes economically feasible.

38.86 The questions of an 'OTC' market and possibly a 'Second Board' market (referred to in Chapter 33) are matters which seem worthy of in-depth consideration by the National Companies and Securities Commission (NCSC).

(iii) Small Business Investment Companies

38.87 An alternative means proposed for attracting equity funds into the small business sector would be to set up Small Business Investment Companies (SBICs) which would function as intermediaries tapping funds from a wide range of savers, including individuals and institutions, and investing these funds in small business equities — principally unlisted ones.

38.88 The potential usefulness of such institutions flows from their purported specialist knowledge, their close association with the businesses and their ability to pool investments and obtain cost and risk economies through portfolio diversification.

38.89 The fact that such institutions in Australia have not undertaken significant business on a commercial basis and that similar ones in the United States are government subsidised suggests that SBICs may not be able to operate successfully at the present time without special tax concessions or other government support. The Committee believes SBICs would be confronted with the same problems which have deterred life offices and other financial institutions from supporting investment in small business — viz. the considerable risk involved, the difficulty of obtaining information and the high overhead costs of carrying a diversified portfolio of this nature.

38.90 Nevertheless the Committee sees SBICs as being an appropriate vehicle, in principle, for promoting greater community participation in small business equities if, for example, the Government wished to provide assistance in the area pending the further development of fuller commercial facilities in a deregulated environment.

38.91 It is possible that small business's access to equity (as distinct from debt) finance might not change substantially in the early years after deregulation. On social or other grounds the Government might feel that official encouragement was desirable immediately.

38.92 It is then a question of what is the most effective and efficient form of encouragement. The Committee favours fiscal means which could take the form of a specific relief of personal tax given to subscribers to SBIC shares. This approach has the following attractions:

- Fiscal assistance would tend to create fewer distortions to the working of the financial system than say financial regulations which require financial institutions to invest in SBIC equities.
- Its visibility to the public would maximise the awareness of its existence at all interested levels.
- As there need be no direct government involvement in the SBICs, the commercial evaluation of the relative risk and rewards of the different small business investments would be largely undisturbed. This may not be the case where the government has an equity position in the SBIC.
- A tax concession at the personal level would concentrate government action on the basic reasons for the 'lack of interest' in small business equities by most **individual** investors — namely, the low expected return relative to the high cost of search and selection of suitable investment opportunities and of dealing in small parcels of shares.

38.93 To ensure that the government assistance was directed to its expressed objective and to minimise the potential for tax avoidance activities, certain safeguards might be necessary — aimed at:

- requiring the SBICs to devote the major portion, if not all, of their portfolios to small business investments;
- securing some minimum spread of such investments;
- preventing SBICs from investing in businesses owned by their shareholders or related interests;
- providing for an adequate spread of shareholding; one might confine the tax concession to publicly listed SBICs;
- limiting the tax concession to **subscriptions of net new** capital to SBICs; and
- providing for adequate supervision to ensure amongst other things that SBICs were not established, wound up and re-established under another name simply to exploit the tax concession, with no real increase in small business investment activity.

38.94 While SBICs might serve as an appropriate vehicle for encouraging the provision of equity to small business, if so desired, the Committee nonetheless sees some potential difficulties:

- The definition and identification of eligible small business for the SBIC's portfolio could pose problems. If the definition were too narrow, few small businesses would benefit; if the definition were too broad, the scheme could prove too costly to government revenue.
- The ability of SBICs to carry a sufficiently diversified portfolio would be influenced by the prospective pool of such investments available, which is much more restricted in Australia than in, say, the United Kingdom or the United States.

- There is a danger that an 'overly generous' scheme in the first instance might foster a mushrooming of SBICs — each one too small and insufficiently diversified to perform with maximum efficiency. Given the need for adequate portfolio diversification and for an organisational structure of sufficient size, there may only be room for a very small number of SBICs of the type proposed, particularly in the short term.
- There is also the question as to whether an SBIC should be allowed to retain in its portfolio an investment which originally began as a small business but which subsequently has grown out of that category. Forced disposal, particularly at a discount, could have implications for the business concerned.

(iv) System of Company Taxation

38.95 As indicated in Chapter 14, the Committee sees the present 'classical' system of company taxation as a factor discouraging small investors from participating in equity markets, thereby restricting the depth and breadth of the new and secondary markets for equities.

38.96 The Committee believes that an integrated system of company taxation would give both small investors and small businesses greater accessibility to the equity market.

D. VENTURE CAPITAL AND INNOVATION FINANCE FOR SMALL BUSINESS

38.97 It is important to distinguish between established, ongoing small concerns and new small business ventures involving untested products, processes and management. Discussion thus far has focused primarily on the former; additional considerations bearing on the latter are now examined.

(a) Present Position

38.98 New business ventures normally involve greater risk and uncertainty than established ones; so too do innovations by established firms, i.e. the commercial introduction of a new product or process (which may or may not involve new technology).

38.99 Because of this greater risk and uncertainty, prime reliance must be placed on equity capital. Heavy use of debt financing would be totally inappropriate, as it would not be feasible for all risks (which can be significant in the case of untested technology) to be reflected in the interest rate. Indeed in no country do debt-financing institutions, including government agencies, seek reimbursement for high risks by charging commensurately high interest rates; such a practice would only serve to increase the risk of insolvency of borrowers.

38.100 As noted previously, there is only a limited venture capital market in Australia.

38.101 It is true that small businesses may seek and obtain equity capital from private sources. In the first instance, this usually involves mobilising the funds of relatives, friends and business associates. Lawyers, accountants, stockbrokers, business agents and officers of various financial institutions often help to extend the circle of contacts.

38.102 The Committee also understands that many large Australian corporations

are continually appraising an array of venture proposals according to their perceived risks and return, and in many cases are prepared to join in the operation on a joint venture basis or alternatively are prepared to develop it within their own organisation.

(b) Assessment

38.103 There are three main factors which probably explain the failure of some new venture and innovation proposals to gain equity and debt funding:[11]

- lack of commercial viability;
- shortcomings in the financial management skills of the entrepreneurs; and
- disinclination, partly arising out of high relative costs, on the part of investors to evaluate untested ventures and products.

(i) Commercial Viability

38.104 In their enthusiasm to develop new venture proposals, some entrepreneurs are often too apt to assume that what is technically feasible is also commercially viable.

38.105 Indeed, a number of small businesses have conceded to the Committee that, in retrospect, the rejection of their original approach for finance was justified, as the venture would not have been successful had it proceeded.

(ii) Financial Management

38.106 The difficulty small businesses face in raising venture capital not infrequently turns out, on closer examination, to be due to a lack of financial experience in preparing an investment proposal rather than excessive caution on the part of the potential investor.

38.107 To the extent that this is true, what is involved is not strictly a **financing** problem but one of business management **education** — an issue examined more closely later.

38.108 Unless such management deficiencies are rectified at an early stage, the business may find itself in financial difficulties — e.g. accepting orders in excess of capacity to supply and poor control of debtors' accounts.

38.109 It is apparent that the initiator of a new venture or innovation is not necessarily the person best qualified to take charge of its commercial development. It might be more appropriate for the innovator to have his idea accepted for development and exploitation by a larger organisation or through the introduction of partners with complementary skills.

38.110 This raises the question whether some small businesses are acting in their own best interests in not allowing a proportion of the equity of the firm to pass out of their hands for fear of lessening their control over the firm.

38.111 It is contended in some quarters that it is not so much a case of being unwilling to seek an outside injection of equity but of being unable to obtain equity on terms acceptable to the entrepreneur.

38.112 This may be true but it is a matter which must be left to the market place,

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11 Interviews of some seventy firms, representing a cross-sectional representation of small business, conducted jointly by the AFSI Secretariat and the Bureau of Industry Economics, lend strong support to this assessment.

which will have regard to such factors as the limited number of potential investors, the relative illiquidity of shares in new ventures and the generally high risk attached to investment in new ventures.

(iii) Disinclination, Evaluation Costs etc.

38.113 There is some impressionistic evidence from the Committee's own and other investigations that the market mechanism has failed to support **all** the venture proposals that offer good prospects of success and attractive risk/return combinations relative to other investment proposals. It is clear that financial markets do not as readily provide equity funds for 'seed-bed' ventures as for ongoing ventures partly because of the substantial costs involved in identifying potentially worthwhile projects, which must be set against their ultimate return.

38.114 The Committee emphasises that the identification of a market disinclination in this respect is not sufficient grounds for government intervention unless it can be demonstrated that it can be rectified in a cost-effective fashion that yields a net benefit to the community. The costs to the community and to the entrepreneurs of overlooking potentially sound projects must be weighed against the danger of the government acting inappropriately either in causing funds to be directed to the wrong projects or more substantially in misinterpreting the nature and magnitude of the problem.

38.115 In this connection it should not be overlooked that under the market system it is the venture capitalist who pays the penalty if a wrong decision is made. He therefore has a strong motive for not buying into unsound ventures or ignoring promising ones. Bureaucrats, on the other hand, have no direct financial interest in the outcome of their decisions and hence are generally not subject to the same discipline in the evaluation of proposals.

38.116 Given the 'venture' character of the finance sought, the Committee is of the view that there is **no** substitute for the judgment of the market place.

(c) Myers Committee Proposal

38.117 The Myers Committee recommended the establishment of a privately owned and administered Venture Capital Corporation, financially assisted by the Commonwealth Government. It saw the Corporation as improving the availability of venture capital for promising inventions and innovations. This is preferred by the Myers Committee to the Crawford Study Group's alternative scheme[12] of a government-administered Innovation Authority to provide technical and financial support, where appropriate, to small and medium-sized firms to enhance their capacity to introduce new and improved technology.

38.118 The Myers Committee's preference appears to be based on the view, supported by this Committee, that investment decisions on venture capital should, as far as possible, be left to the market. Nevertheless, it believed that the establishment of a private sector venture capital institution would clearly require government support.

38.119 The Myers Committee's proposal of government sponsorship would involve a government commitment of loan funds up to a maximum of $25 million over fifteen years, with such loans being matched by private investors in the Corporation. It is assumed that the government loan is intended to be at interest

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12 Crawford Report, op.cit, pp. 7.34–5.

rates below commercial rates for a risk of that nature; otherwise there would be no reason for government involvement.

38.120 The Committee makes the following observations on certain aspects of that particular proposal:

- Although the scheme would limit the government involvement to the first fifteen years, there is clearly a considerable risk that the Government's presence would become permanent.[13]
- Because, as proposed, the loan ceiling would be applied for the full period of the program — i.e. with no separate ceiling as to annual commitment — the ceiling could well be reached fairly quickly and create pressure for its lifting.
- There is a potential danger that direct loan advances would create a public perception that the Government is involved directly in the operation of the venture capital institution. This would expose the institution to political pressures — e.g. to channel its funds to ventures favoured by particular interest groups rather than areas determined on broadly based economic criteria. Private investors in the institution might also expect some government protection against losses.
- It is arguable whether government involvement would result in additional ventures being launched. There would be an incentive for those businesses which presently would have received capital finance from commercial sources to seek the funds from the Corporation because of its presumably more attractive terms.

(d) Preferred Approach

38.121 As indicated elsewhere in the Report, in the Committee's opinion the most effective way to deal with a 'rigidity' in the market is to apply measures addressed specifically to that 'rigidity'. In the context of venture capital, apart from the small size of the Australian market, two possible inhibiting factors are: firstly, the incapability of most financiers to adequately evaluate high technology products and processes; and secondly, a degree of risk aversion on the part of investors — both individual and institutional.[14]

38.122 If for these reasons there were some reluctance on the part of investors to carry high risk assets in their portfolio, the alleviation should be sought **in the first instance** in a critical review of any inhibiting regulation and taxation arrangements. These are covered in various parts of the Committee's Report. The proposals to deregulate parts of the financial system should enable institutions to adopt a more flexible approach to risk. The recommendations in Chapters 14 and 16 in the tax area may also contribute in a small way to the achievement of this objective.

38.123 Beyond this, if the Government, on social or other grounds, wished to provide positive support for innovation and new ventures, the Committee believes that its proposal (see paragraphs 38.87–94) in respect of fiscally encouraged SBICs would provide the most effective and efficient basis for government support.

13 This risk would be less with a proposal like the SBIC proposal.

14 There is, however, no evidence to suggest that attitudes to risk in Australia are abnormal (see also Chapter 34). R. H. Grasley came out with a similar conclusion for Canada in a study prepared for the Ministry of State for Science and Technology, *The Availability of Risk Capital for Technological Innovation and Invention in Canada*, (monograph) 1974.

Accordingly, it believes that any desired government support for new ventures and innovation should be on a comparable basis to that proposed for small businesses.

38.124 Indeed, the Committee envisages that, if established, many SBICs would include new ventures and innovative small businesses in their investment portfolios and would themselves assume the role of venture capital corporations. It may be expected that certain SBICs will choose to specialise in high technology innovation finance.

E. FINANCIAL MANAGEMENT AND INFORMATION

38.125 From discussions with small business representatives and with lenders to small business, the Committee formed the view that the apparent lack of success of many small businesses in raising finance is often attributable in some degree to:

- inadequacies in financial management;
- lack of knowledge about the range of finance available; and
- inability to prepare a persuasive case once an appropriate source of finance has been identified.

38.126 Significantly, these factors are not always appreciated by the businesses themselves. This could suggest that the problem was partly, perhaps importantly, one of education, information communication etc., rather than the absence of financial facilities.

38.127 Reference was made in a number of submissions to the need for greater government involvement to improve the financial and management sophistication of small businesses, including the provision of direct management services to small businesses.

38.128 The Committee has examined the types of financial services for small businesses currently offered by governments. The situation is that:

- All the State Governments have Small Business Advisory Bureaus whose main function is to inform small businessmen of the types and sources of finance offered in the market place, the names of accountants and their particular field of specialisation. In addition some offer limited financial counselling services and play a co-ordinating liaison role in connection with state assistance programs relevant to small businesses (e.g. in the decentralisation area). Technical colleges also provide relevant part-time courses in a number of states.
- The Commonwealth Government, through the Department of Industry and Commerce, also performs a co-ordinating liaison role and is directly involved in some areas where it has proved more economical to provide services at the federal level — e.g. in the publication and distribution of small business literature and management training packages.
- The Reserve Bank and a number of trading banks also issue information on the sources and types of finance available to businesses. Trading banks in some cases provide a wide range of financial advice to their small business customers.
- Various industry associations catering for small businesses conduct in-house management seminars and disseminate financial information and industry news through newsletter services.

38.129 The Commonwealth Department of Science and Technology organised in February 1981 a forum, called 'Creating High Technology Enterprises: Roles for the Financial Market', with the aim of bringing together bankers, financiers and representatives of industries at a central venue to discuss various aspects of the financing needs of high technology enterprises and to promote better understanding between the prospective borrowers and lenders in this area of venture financing. The Committee understands that more of such forums are being planned.

38.130 Despite these various initiatives in recent years aimed at closing the financial information gap, many small businessmen still appear to be unaware of the facilities available and the requirements of lenders.

38.131 The problem might be overcome to some extent if governments, trade associations and banks were to regularly publicise the availability of the information and the facilities, not only to the businesses themselves but also to their accounting, taxation and other professional advisers. One obvious avenue would be advertising in newspapers, industry newsletters and trade and accounting journals. In Chapter 44, the Committee discusses the adequacy of existing information facilities.

F. CONCLUSIONS

38.132 It is obvious that small businesses are not equal to large businesses in their access to the financial markets. In particular:

- loans are more expensive and (in order to protect the lender) security requirements can be more stringent;
- equity funds are more difficult and costly to obtain, especially for new ventures and innovation, and disinclination by investors understandably exists; and
- small business proprietors do not usually have the same financial expertise as larger corporations in presenting their applications for finance.

38.133 In the opinion of the Committee, these disabilities, for the most part, do not reflect in-built technical deficiencies in the allocative role of the financial system. Rather, they basically derive from:[15]

- the necessarily higher cost of lending and investing in small amounts;
- the higher risk of lending to and investing in small businesses; and
- the inability of small business proprietors to take full advantage of the opportunities available, whether due to lack of financial sophistication or a reluctance to dilute control.

38.134 The Committee recognises that these factors may be compounded by:

- the intrinsic smallness and geographical spread of the Australian market;
- the risk-averse characteristics of many investors — often accentuated by insufficient knowledge of or familiarity with high technology, science-based activities;
- the limited ranges of institutional or broking facilities for the placement of unlisted shares;

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15 It should also be remembered that the small business proprietor's assessment of the viability and prospects of his venture might often be out of line with the market's assessment.

- inadequate awareness by many small businesses of the sources and types of funds available; and
- distortions caused by government controls and regulations.

38.135 The Committee's proposals elsewhere in the Report for 'freeing up' the financial system and strengthening its competitive base would remove most of the major constraints inhibiting the market from responding to unexploited opportunities; as well, the Committee's general tax recommendations should assist.

38.136 Against this background, the Committee sees no need, on efficiency grounds, to recommend further government initiatives in respect of small business and new ventures.

38.137 At the same time, the Committee is conscious that, on social or other grounds, the Government may consider it desirable to provide some assistance in this area. If this is so, the policy instrument needs to be carefully chosen to ensure it is the most cost-effective one available.

38.138 For reasons discussed earlier, the Committee is least well disposed to government financial assistance for:

- loan insurance/loan guarantee schemes;
- specialist small business financing institutions; and
- over-the-counter markets for unlisted shares.[16]

38.139 Experience in other countries (see Appendix 38.1) also suggests a need for caution in adopting some of the schemes operating overseas.

38.140 The Committee believes that, if the Goverment were to consider it socially appropriate to provide assistance in this area, the following form and method would cause least disturbance to the structure and efficiency of the financial system:

- **Encouragement could be given to the establishment of private Small Business Investment Companies (whose primary role would be to invest in the equity of small businesses, including new ventures and innovations) by making subscriptions to their shares eligible for personal tax relief.**

16 But see paragraph 38.86.

GOVERNMENT FINANCIAL ASSISTANCE FOR SMALL BUSINESS OVERSEAS

1 A selective survey of government financial assistance schemes for small business in the United States, Canada and the United Kingdom is provided in this appendix.[1]

2 The Committee's examination of these schemes has benefited from the discussions between representatives of the Inquiry and the representatives of the various overseas agencies and government officials.

3 Because of differences in the economic environment and community needs, and other special factors, there is a need for caution in applying overseas experience to Australia. It must be borne in mind, for example, that many of these overseas schemes:

- Had their genesis in postwar reconstruction programs aimed at assisting business generally rather than small businesses per se.
- Incorporate elements of welfare assistance. The Economic Opportunity Loans Program (for minority groups) and the Handicapped Assistance Loans Program, which are two of the many administered by the US Small Business Administration, are more akin, in their functions, to social welfare agencies.
- Were primarily directed at evening out regional disparity in employment and economic growth opportunities.
- Were largely seen, against the particular political environment, as more 'palatable' alternatives to the removal of government and other compulsory requirements that were impeding the flow of funds to small business. They were not an ideal solution from the economic viewpoint.

4 The Committee was told that there has not been any comprehensive appraisal of the cost-effectiveness of the various schemes in the countries surveyed, understandably given the dearth of relevant information. However, the US Comptroller-General, after a series of audits, made the following observations of the operations of the US Small Business Agency:

- its financial programs have had only a marginal effect on the small business sector, benefiting only a small fraction of the estimated thirteen million small businesses;
- numerous loans were approved which transferred the risk of loan payment from bankers and other creditors to the SBA, without increasing the overall amount of lending;
- some loans were made to wealthy businesses not intended to receive assistance; and
- loans were approved in some cases where there was doubt as to the borrower's capacity to repay.

1 Much of this summary is drawn from pamphlets and reports supplied by the various institutions concerned, the Interim Report of the Wilson Committee (UK), *The Financing of Small Firms*, March 1979; the Report by the Small Business Advisory Council, *Finance for Small Business*, AGPS, Canberra 1980; and information provided by the Department of Industry and Commerce.

Small Business Administration

5 The Small Business Administration (SBA) was established in 1953 as a federal agency with the charter to provide financial assistance, management training and counselling to small businesses, and to facilitate easier access for small businesses to government contracts.

SBA Loans and Loan Guarantees

6 The SBA provides loans to eligible small businesses unable to obtain private financing on reasonable terms. Loans can be provided in three different ways:

- the SBA can offer a guarantee of up to 90% of a loan which a bank or other lender agrees to make;
- the SBA can participate with a bank or other lender in a loan (with the SBA's share not to exceed 75% of the loan);
- where loan guarantee or participation loans cannot be arranged, the SBA can provide the financing itself if it were appropriate for it to do so; direct loans have diminished in importance over recent years.

7 Loans can be provided for the conversion or expansion of plant and equipment, building and construction and for working capital.

8 The maximum amount set for a direct or participation loan is US$350 000 and US$500 000 for loan guarantees.

9 Interest rate charges on SBA-backed loans are roughly 2–3% above normal bank rates and are varied in line with bank interest rates. The term of SBA loans or loan guarantees is normally ten years as a maximum and six years for working capital, but loans for construction or for the aquisition of real estate may have a maximum of twenty years.

10 The fee for SBA loan guarantees are 1% of the guaranteed portion of the loan if the loan matures in more than twelve months or 0.25% if it matures within twelve months.

11 Collateral on SBA loans can include real estate or chattel mortgage, the assignment of warehouse receipts for marketable merchandise, the assignment of certain types of contracts, guarantees or personal endorsement, and the assignment of current receivables.

12 In addition to this 'regular' business loans program, the SBA also has a number of separately administered loan programs. Most of these seek to achieve particular social objectives; for example, the Economic Opportunity Loans Program (aimed at assisting the minority groups) and the Handicapped Assistance Loans Program.

Small Business Investment Corporations

13 The Small Business Investment Corporations (SBIC) program was established in 1958 to encourage private investment companies, through a licensing scheme, to provide long-term loans, equity and venture capital, and management services to small businesses. The licence, issued by the SBA, allows an SBIC to raise its funds through the sale of government-guaranteed debentures in return for concentrating their investments in new or small businesses.

14 To qualify for a licence the SBIC must:

- have a minimum shareholders' funds of US$500 000;
- provide the SBA with full background and details of the major shareholders;
- satisfy the SBA that management is adequately qualified; and
- have no more than 20% shareholding in any company without SBA approval.

15 SBICs can have their shares publicly traded.

16 SBIC finance is only available to those businesses which have:

- assets of less than US$9 million;
- net worth of less than US$4 million; and
- average net income after taxes of less than US$400 000 in each of the preceding two years.

17 Alternatively, the criteria established by the SBA for its business loans program may be used.

18 Loan finance provided by SBICs is usually for a minimum of five years. The security required for loans takes the form of second mortgage, personal guarantees or other types of collateral not acceptable to bankers. Interest rates on loans are determined by negotiation between SBICs and prospective customers, but are subject to maximum interest rates established by legislation in particular states. Repayment schedules can be flexible depending on the circumstances of each case and the possibility exists for repayment holidays where appropriate. SBICs also provide equity finance to small businesses although they are not permitted to assume a controlling position in individual enterprises.

CANADA

Federal Business Development Bank

19 The direct involvement of the Canadian Government in small business support measures goes back to 1944, when the Industrial Development Bank (IDB) was established as a subsidiary to the Bank of Canada to provide debt finance to eligible small businesses which were not able to obtain finance on reasonable terms and conditions from conventional sources.

20 In 1975, the Federal Business Development Bank (FBDB), a separate crown corporation, was formed as a successor to the IDB. The activities of the FBDB's predecessor have continued, but with some changes. The FBDB has clear authority to make equity investments in small businesses; it is also authorised to provide loan guarantees.

Loans

21 There is no stated limit in the FBDB charter on the size of loans that can be made to individual businesses or the size of business which may be financed. There is a general guidance, however, that particular attention be paid to the needs of small business

22 There is no pre-set term and repayment schedules on FBDB loans. Loan repayment terms range between one and twenty-five years, with the average being about eight years.

23 Loans below Can$250 000 are at concessional rates, larger loans are at normal commercial rates.

24 The FBDB seeks, wherever possible, to obtain a reasonable amount of security — usually a realty or chattel mortgage. In making its assessment, it also looks at the future prospects of the enterprise.

25 The loan guarantee instrument has been used only infrequently.

Equity

26 Where an equity investment is involved, the FBDB assumes a minority ownership in a small company by purchasing shares, which may later be redeemed by the private owners of the business. To date equity investments by the FBDB have not been significant.

Small Business Loans Act

27 Under the Small Business Loans Act (SBLA), first enacted in 1961, the government guarantees against loss loans made by commercial banks and other designated private sector institutions to small businesses. The following criteria apply:

- a small business is defined as a business whose gross annual revenue does not exceed Can$1.5m;
- loans must be used for specified purposes, essentially purchases of land, premises, plant and equipment and so secured;
- loans are normally repayable over a ten-year period;
- the guaranteed loan maximum is Can$100 000;
- the interest rate is set at 1% over the prime lending rates of the chartered banks and floats for the duration of the loan.

Enterprise Development Program

28 Under the Enterprise Development Program (EDP), launched in 1977, the Government offers **selected** small and medium-sized businesses, undertaking high risk but viable projects which promise attractive rates of return, the following financial assistance:

- grants to subsidise the development cost of a new product or process (up to a limit of 75% of eligible costs); and
- loan insurance covering business expansion; the loan insurance can be provided for 90% of a term loan from conventional lenders for an annual fee of 1% of the loan.

UNITED KINGDOM[2]

National Research Development Corporation

29 The National Research Development Corporation (NRDC) was established by the British Government in 1948. The Corporation is financed by loans from the Department of Industry.

30 Its main statutory function is to provide last recourse finance for industry and trade specifically oriented to the exploitation of inventions and technological innovation where adequate finance on reasonable commercial terms is not available from other sources. NRDC funding is intended to supplement, rather than compete with existing conventional sources of finance.

31 The NRDC now operates under the 1967 Development of Innovations Act, with its borrowing powers set at £50 million. To qualify for NRDC assistance, projects must be genuinely innovative, potentially viable and 'in the public interest' — the latter apparently open to wide interpretation.

32 There are two main ways in which NRDC makes its contribution:

- through **joint venture projects**, in which they pay the client company an agreed proportion of the costs incurred in connection with the project and recover this through a percentage levy charged on subsequent sales; and
- through the provision of **equity and loan finance**. This is the usual method in pure start-up propositions. Interest charged on loan finance is slightly above bank rates.

33 Overall management and capital, and the rights in any inventions, usually remain with the client company, except in the few cases where the NRDC is the sole source of funds.

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2 A major institutional source of finance for small businesses in the UK is the Finance for Industry Group (FFI), which includes the Industrial and Commercial Finance Corporation and the Technical Development Capital Limited. **The FFI is essentially a commercial concern.** Although there is a minority indirect shareholding by the Bank of England, it is not regarded as an instrument of government financial assistance. Ownership is split between the Bank of England (15%) and the London and Scottish Clearing Banks (85%).

National Enterprise Board[3]

34 The National Enterprise Board (NEB) was set up in November 1975 under the Industry Act 1975 with the broad objectives of developing or assisting enterprises that demonstrated good prospects for promoting industrial efficiency and international competitiveness, and providing productive employment, especially in areas of high unemployment. It is a public corporation, financed out of public funds, and has the power to hold shares in companies or to provide loan finance. It operates without compulsory powers and is not intended to be an instrument of government subsidy.

35 As a general rule, the NEB only considers investments of over £100 000, though no rigid criterion of size is adopted. Investments usually take the form of share capital. Normally the NEB expects to have an equity stake of not less that 20% (actual or potential) with a suitably attractive return. At 15 November 1978 the NEB had five shareholdings less than £100 000. The NEB's loan rates are comparable to those of commercial institutions.

36 In October 1978, the NEB and the Midland Bank set up Newtown Securities (Northern) Limited as a joint venture based on the bank's Newcastle regional office. Its function is to provide loan capital in amounts of between £5000 and £15 000 to small businesses which are unable to obtain finance elsewhere, particularly because of lack of security. They are prepared to consider new as well as existing businesses and in principle do not discriminate between the service and industrial sectors. Interest rates are slightly higher than normal commercial rates to reflect the additional risk involved.

Council for Small Industries in Rural Areas

37 The Council for Small Industries in Rural Areas (CoSIRA) was formed in 1968 to support employment in small businesses in rural parts of England. It is wholly financed by the Government through the Development Commission. CoSIRA provides advice, training facilities and loans to small manufacturing and service firms employing up to twenty skilled workers (and any number of unskilled workers) in rural areas and country towns not exceeding 15 000 inhabitants. Small tourist enterprises providing overnight accommodation in the rural parts of the Government's Development Areas can also be assisted. Agriculture, horticulture, the retail trades and the professions are not eligible.

38 Up to 60% of cases (and 80% by value) of total loans made by CoSIRA are now applied to building projects, for which they can finance up to 80% of the cost with repayment periods up to twenty years. From January 1978 CoSIRA has been able to make loans at concessionary rates for projects which create additional employment. Commercial rates are charged for other projects.

Loan Guarantee Scheme

39 A loan guarantee scheme commenced operation in June 1981 on a three-year trial basis. The scheme provides for government underwriting of up to 80% of the value of a loan made by prescribed institutions (which in the pilot scheme are the major clearing banks and the Industrial and Commercial Finance Corporation) to eligible small businesses. The loan guarantee ceiling is £75 000. A 3% premium is charged on the guaranteed portion of the loan.

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3 The NRDC and the NEB have recently announced a merger between the two bodies (see *The Economist*, 25 July 1981).

CHAPTER 39: RURAL FINANCE

39.1 The **level** of government assistance to the rural sector and any other sector can impact significantly on the financial system and in particular on the availability of funds to other groups. Nevertheless, because of the wide range of economic and social issues involved it is not a matter on which the Committee expresses any judgment. On the other hand, the **form** of such assistance — more particularly, whether it should be delivered through the financial system or by other, more direct, means — is a question that falls clearly within the terms of reference of the Committee. From its point of view some assistance currently given to the rural sector could be provided just as effectively by alternative methods which would cause less disturbance to the efficient operation of the financial system.

A. EXISTING ARRANGEMENTS

39.2 The following briefly summarises existing official arrangements to lower the cost or improve the availability of rural finance, especially longer term finance, with particular emphasis on the **objectives** of each arrangement. More detailed information is to be found in the Interim Report;[1] summary statistics on rural sector indebtedness are provided in Table 39.1.

(a) Reserve Bank: Rural Credits Department

39.3 The Reserve Bank's Rural Credits Department (RCD) makes short-term advances to statutory marketing authorities and to co-operative associations of primary producers to assist in the marketing, processing or manufacture of primary produce. Traditionally the largest borrower has been the Australian Wheat Board, which has typically accounted for around 75% of loans advanced. Annual peak RCD loans outstanding over the decade of the 1970s were in the range of about $350–$1200 million, averaging out at about 1% of total assets of all financial institutions.

39.4 RCD loans to marketing authorities allow some rural producers access to cash against the security of their produce prior to sale: some such loans are secured by government guarantees. Participating producers have their income insulated, to some extent, from delays in the final sale of farm produce. Interest rates charged have typically been concessional (relative to commercial rates). As well, half of the net profits of the RCD is appropriated to the Rural Credits Development Fund, which is used to finance research on rural industry matters.

39.5 Over recent years the extent of RCD involvement in the provision of marketing finance to the Wheat Board has been substantially reduced: the Board

1 See especially Chapter 2, paragraphs 2.54–59; Chapter 5, paragraphs 5.38–40, 5.47–55 and 5.107–111; Chapter 21, paragraphs 21.11–64; and Chapter 30, paragraphs 30.54–61.

TABLE 39.1: RURAL INDEBTEDNESS ($m)

As at 30 June	Major trading banks (a)(g)				Pastoral finance companies(g)	Cwlth Development Bank (c) (g)	Assurance societies	Ex-service settlement	Other govt agencies (incl. State banks) (g)	Total institutional indebtedness (d)	Instalment credit (incl. hire purchase) (e)	Loan by merchants solicitors' trusts etc. (e)	Estimated rural gross indebtedness	Reserve Bank Rural Credits Department (f)
	Term loan fund	FDLF (b)	Over-draft	Total										
1951	n.a.	n.a.	n.a.	250	101	8	17	43	90	509	n.a.	n.a.	n.a.	34
1961	n.a.	n.a.	n.a.	451	213	21	48	114	138	985	n.a.	n.a.	n.a.	180
1967	94	21	636	751	286	120	81	92	261	1 590	n.a.	n.a.	n.a.	372
1968	113	45	760	918	314	143	97	88	297	1 857	n.a.	n.a.	n.a.	230
1969	127	67	745	939	338	162	113	83	318	1 953	n.a.	n.a.	n.a.	489
1970	131	79	787	998	349	176	128	80	351	2 082	n.a.	n.a.	n.a.	349
1971	122	90	782	994	333	192	129	83	374	2 104	201	858	3 163	310
1972	116	113	733	963	293	202	125	79	432	2 094	187	845	3 126	266
1973	121	215	715	1 051	303	198	117	71	481	2 221	206	704	3 131	213
1974	133	267	761	1 161	371	203	107	61	499	2 402	145	422	2 969	205
1975	122	286	812	1 220	279	232	104	58	554	2 447	145	484	3 076	200
1976	119	324	874	1 317	254	243	96	54	633	2 597	217	509	3 323	209
1977	121	380	896	1 397	200	254	86	49	696	2 682	192	821	3 695	587
1978	122	461	976	1 560	200	280	80	43	797	2 960	n.a.	n.a.	n.a.	481
1979	250	586	944	1 780	243	292	70	39	877	3 304	n.a.	n.a.	n.a.	559
1980	350	715	1037	2 103	322	312	67	34	932	3 770	n.a.	n.a.	n.a.	274

(a) Figures for the major trading banks refer to the second Wednesday in July.
(b) Farm Development Loan Fund.
(c) Excludes equipment finance under hire purchase arrangements.
(d) Excludes indebtedness to hire purchase companies, trade creditors and private lenders.
(e) ABS estimates. Because of considerable changes in the basis on which data were collected, statistics for 1975 are not directly comparable with those derived from surveys in previous years.
(f) Average of weekly figures for June.
(g) From 1979 includes loans refinanced by the Primary Industry Bank of Australia (PIBA); as at June 1979 and 1980 PIBA refinanced loans outstanding totalled $105 million and $214 million respectively to approved prime lenders.

Sources: Reserve Bank of Australia, *Bulletin*;
Australian Bureau of Statistics, *Estimate of Gross Indebtedness of Agricultural Producers in Australia.*

Source of Table: Bureau of Agricultural Economics' submission to the Inquiry (updated).

now finances a large part of its seasonal funding needs by the issue of commercial bills and promissory notes on the open market. The arrangement, nonetheless, provides for some reimbursement to the Wheat Board for any excess of the interest costs incurred over and above what would have been incurred had it borrowed from the RCD. The subsidy element is met from the Commonwealth Budget.

(b) Commonwealth Development Bank[2]

39.6 The Commonwealth Development Bank (CDB) provides finance for primary production or for the establishment or development of business undertakings (including undertakings relating to primary production), particularly small undertakings. Historically the bulk of CDB loans have gone to the rural sector for **farm development** purposes but its operating rationale has changed over time to enable provision of some carry-on finance and to broaden its operating base beyond the rural sector.

39.7 The CDB provides finance on a 'last recourse' basis. In assessing loan applications, it has regard to future prospects and not just the security available or the 'past banking history' of the applicant.

39.8 CDB loans are mainly medium to long term and rarely exceed $300 000. CDB loan interest rates contain a concessional element in that:

- they are generally at or below those that would be charged by a commercial bank;
- the loans may not always be as fully secured; and
- the costs of providing management support and more extensive loan assessment services are not fully passed on to users.

(c) Primary Industry Bank of Australia

39.9 The Primary Industry Bank of Australia (PIBA) is a joint venture of the Commonwealth Government, the major trading banks, and a consortium of some state banks. The Commonwealth Government has provided some funds at a concessional interest rate. These funds supplement public borrowings at commercial interest rates.

39.10 PIBA is a **refinance** bank, providing long-term funds on concessional terms to accredited 'prime lenders' to on-lend for purposes relating to primary production. Risk assessment is the responsibility of the prime lenders and the credit risk is borne by them; as part of the arrangement between banks and the government, it has been agreed that the prime lender will not have a margin of more than 1.5% per annum.

(d) Trading Banks

39.11 The principal source of credit for rural sector borrowers is the commercial banking system. Bank lending techniques such as the overdraft are particularly well suited to the seasonal and variable credit needs of rural producers. For the most part rural producers borrowing from banks have for some time now been treated like other bank customers and they generally receive no special advantage. Nonetheless, when seasonal conditions have been adverse the banks have usually responded to government requests for rural loan applications to be given sympathetic treatment and, on occasion (such as recently), for rural borrowers to

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2 The Commonwealth Development Bank is discussed more fully at Chapter 28.

be shielded from the full impact of general interest rate increases. Moreover, many rural borrowers, being relatively small, have been assisted by the general policy of below-market interest rates on bank loans under $100 000.

39.12 Additionally, the major trading banks have been encouraged to make longer term loan funds available to rural producers; the special Term and Farm Development Loan Fund arrangements established in the 1960s are an illustration.

(e) Term and Farm Development Loan Funds

39.13 The Term Loan Fund (TLF) arrangement is a channel for the provision of term loan funds, mainly for capital expenditure, and mainly to smaller businesses — including rural producers. Term loans are usually for periods of three to ten years and at interest rates a little above bank overdraft lending rates. The participation of the trading banks was initially encouraged by releases of bank funds from SRDs, which augmented the banks' existing capacity to provide term loans.

39.14 The Farm Development Loan Fund (FDLF) arrangement is similar to that for TLF loans. The facility is directed to the provision of medium to long-term development funds to the rural sector. Interest rates on FDLF loans have also, for the most part, been a little above bank overdraft lending rates.

39.15 Banks have been funding new Term and Farm Development Loan Fund loans from their freely available resources for some time now without any reduction in the pace of lending. The last release from SRDs for this purpose was in September 1978.

(f) Rural Adjustment Scheme

39.16 Since 1977 all government-sponsored rural **adjustment** measures have been co-ordinated in a single scheme, the Rural Adjustment Scheme, which makes available concessional loans and direct grants to expedite the process of structural adjustment.

39.17 Funds are provided by the Commonwealth through Rural Adjustment Authorities in each state, which set interest rates charged. Loans are of a 'last recourse' nature and made to farmers with sound prospects following the proposed structural adjustment.

(g) State Banks and Other State Agencies

39.18 A number of rural credit **assistance** schemes are administered by state government banks or other state agencies. Assistance is given in the form of direct grants or by way of finance on concessional terms and conditions. Some states make provision for the government to guarantee loans which, reflecting the elimination of risk, are then made at a lower rate of interest.

B. CONSIDERATION OF THE ISSUES

(a) Availability of Long-term Finance

39.19 The major farm bodies consider that while the availability of finance in the short and medium-term categories has generally been adequate, commercial lenders have been less forthcoming at the longer end of the spectrum. It is agreed that high rates of inflation have exacerbated the problem.

39.20 The Committee has sought to determine why it has been necessary to encourage private financial institutions into longer term rural lending through such arrangements as the TLF and FDLF, and to establish specialist institutions, such as the CDB and PIBA, to assist in filling perceived 'gaps' at the long end.

39.21 Clearly important contributing factors have been the deposit maturity and interest rate controls on the major suppliers of rural credit, the trading banks, which have inhibited them from making longer term loans and charging an interest rate thereon commensurate with the higher risks and costs involved.

39.22 At the same time, it is by no means clear to the Committee that interest rate controls on small loans assist the borrowers they are intended (at least in part) to benefit. In particular, they may reduce the availability of funds, especially longer term funds, to small moderately risky borrowers from controlled institutions; those unsuccessful in obtaining low cost bank funds — including many rural producers — generally have to pay higher rates for loans from alternative sources.

39.23 The Committee considers that decontrolling bank interest rates will assist in increasing the general availability of long-term finance to rural borrowers. It believes that the **average** cost of funds overall may not change much. Some at present relying solely on 'small' loans (at less than market rates) from banks could well have to pay more; but banks as a result should be able to serve many borrowers presently relying, in part or whole, on higher cost lenders.

39.24 The Committee discusses later (Section D) the appropriate methods of subsidising the cost of long-term rural finance, if that were the Government's wish. However, one particular suggestion put to the Committee calls for immediate comment. This is the proposal that the Government establish a **land bank** along the lines of the Saskatchewan Land Bank Commission in Canada. Such an institution would acquire land (usually existing farming operations) which would subsequently be leased, long term, to farmers. This would:

- provide an alternative for farmers unwilling or unable to commit themselves to a capital investment in land sufficient to establish and maintain a viable operation, and
- facilitate the transferring of family farms from one generation to the next.

39.25 To the extent that this proposal envisages the Government as a permanent owner of farms, it is not strictly an intervention in the financial system and is in that regard outside the scope of this Inquiry. If it were intended that some of the land should pass back into private ownership — by progressive sale by government of the land owned — the arrangement would have many of the features of a government financial institution.

39.26 Bearing in mind its approach both to government financial institutions of a commercial nature (Chapter 26) and those established to assist particular sectors (Chapter 36), the Committee would not be in favour of the Government establishing a rural land bank. It is not persuaded that the private sector would fail to meet an effective commercial demand for this service. If concessional terms were to be involved, the Committee is of the view that established arrangements — such as those involving PIBA or the CDB — and the alternative of direct assistance to potential borrowers would be preferable to another overlapping financial enterprise involving government.

(b) Flexibility of Financing Arrangements

39.27 The variability, uncertainty and seasonality of rural income flows have

prompted requests for lending institutions to provide greater flexibility in loan repayment arrangements.

39.28 Repayment flexibility assists in offsetting the income variability faced by the rural sector and can reduce pressures for relief assistance. The Committee considers repayment terms and conditions to be an issue for commercial negotiation. For their part banks need to be satisfied that the arrangement is commercially sound. Subject to that, the Committee understands that banks do at times adopt a quite flexible approach to the timing of reductions in advances drawn under overdraft limits and other loans.

39.29 It is true that in a regulated system with rates straining against permitted maxima, and hence banks having to adopt non-price rationing devices, there has been limited scope for flexible arrangements to develop. Nonetheless, the Committee has not had drawn to its attention any evidence of unreasonable 'selling up' pressures on rural borrowers temporarily suffering hardship.

39.30 The recommended deregulation of bank interest rates should go a long way towards eliminating any problem with regard to flexible arrangements.

39.31 A number of government-supported schemes aimed at evening out rural income flows over time already exist, e.g. the tax averaging arrangements (including the Income Equalisation Deposits scheme). On particular occasions governments have also provided direct cash assistance to help farmers cushion the effects of exceptionally difficult times.

39.32 If governments wish (for social or other reasons) to further cushion farmers from the effects of rural instability, the Committee sees an extension of such income support programs as preferable to any attempt to induce lending institutions to offer loan repayment terms not consistent with commercial considerations. They create less distortion for the financial system, the costs are more clearly visible, and spread more equitably throughout the community.

39.33 The Committee also sees a potentially greater role for commodity futures markets in insulating rural incomes to some extent from the effects of market volatility. (In this connection the Committee notes the recent moves by the Government to treat profits or losses arising in commodity futures hedging operations as revenue for taxation purposes.)

(c) Structural Adjustment Assistance

39.34 The rapid rate of technological change in farming (involving increasing capital intensity) and, for many rural industries, a decline in the terms of trade over the long term have created pressures for structural adjustment within and out of the industry. Such adjustment permits a rationalisation and consolidation of farm operations and a relocation of 'surplus' resources elsewhere in the economy. Various submissions have claimed that more generous structural adjustment assistance must be provided by governments to ensure that rural structural adjustment occurs at a desirable pace.

39.35 The Committee can readily envisage situations where finance on commercial terms and conditions might not be available for facilitating adjustment. For example, where substantial long-term finance is needed for one farmer to buy an adjacent property and the purchasing farmer's own property is barely viable as a separate unit, it may be unlikely that the necessary finance will be forthcoming from commercial organisations, even though the combined operation might prove viable.

39.36 If governments wish to intervene in such circumstances, the Committee has a strong preference for **direct assistance** from the Budget but accepts that this might need to be channelled through a particular lender or group of lenders. (See Chapter 36.)

(d) Loan Appraisal Skills

39.37 A common complaint is that banks and other commercial financial institutions lack adequate loan appraisal skills to properly assess rural loan applications. Many local branch managers, it is said, do not have sufficient background in agricultural businesses.

39.38 Farmers believe that, as a result, too much emphasis is placed on the provision of security with insufficient regard for longer term prospects.

39.39 The Committee is sympathetic to the demands of rural sector borrowers for skilled financial advice and competent loan assessment. At the same time it should not be overlooked that the present regulatory framework gives financial institutions (particularly banks) little incentive to make sophisticated evaluations of borrowing proposals. It is understandable that lenders, forced to ration funds at a fixed price, rely on conservative security rules.

39.40 The Committee is confident that its recommendations to reduce the incidence of direct regulation will do much to restore incentives for lenders to acquire the necessary loan appraisal skills to service borrowers.

C. METHODS OF GOVERNMENT ASSISTANCE

39.41 The Committee recognises that in a continuing uncertain inflationary environment, long-term rural finance may not be readily available from commercial sources — even in a substantially deregulated financial system. This is because both borrowers and lenders seek to avoid long-term contractual commitments in such a situation. This is not a 'problem' unique to farmers. Governments may, however, consider it socially desirable to make long-term finance more readily available to farmers than to other groups in the community.

39.42 As was noted earlier, existing government assistance to the rural sector is forwarded through both fiscal and financial channels and in some cases, like PIBA, a mixture of the two.

39.43 While there would be efficiency gains in making greater use of the fiscal channel to deliver sectoral assistance direct to the target group, this must be viewed as a long-term objective. As a first step, however, government assistance via the financial system should, in the opinion of the Committee, be rationalised.

(a) Lending Directives

39.44 The Committee has elsewhere proposed that the monetary authorities relinquish their general capacity to directly intervene in the commercial judgments of banks and others concerning the provision of finance to private sector borrowers, including those in the rural sector.

39.45 At times, banks have been subject to specific directives from the authorities with regard to both the volume of, and interest rates charged on, loans to rural lenders. Indeed recently, banks were asked to charge lower rates to rural borrowers in drought-affected areas. The Committee's discussion in Chapters 4

and 36 makes it clear that it sees this method of meeting a sectoral social need as inappropriate and less effective than other techniques available to government. This is true not only from the point of view of efficiency of the financial system but also in terms of effectiveness, and the equitable sharing of the cost of the assistance.

39.46 The Committee ***recommends*** that **assistance to the rural sector should be effected by means other than controls over the direction, volume or cost of lending by banks and other intermediaries.**

39.47 In the remainder of this section, the Committee is concerned with other rural finance assistance institutions and schemes which involve government intervention.

(b) Term and Farm Development Loan Funds

39.48 The lending operations of the major trading banks conducted in the context of the Term and Farm Development Loan Fund arrangements come within the Committee's purview because, at least until recently, it was the practice for those Funds to be financed in part by releases of banks' Statutory Reserve Deposits. In terms of their ultimate results, such releases involved a redeployment of bank credit from non-rural to rural sectors. As a general principle, the Committee is opposed to the use of Statutory Reserve Deposits to fund special purpose loans. Such arrangements rest on the misconception that SRD deposits represent a pool of idle funds that can be tapped without affecting monetary policy or reducing the availability of funds to other sectors of the economy.

39.49 The Committee favours the phasing out of the separate FDLF and TLF arrangements in so far as they entail any commitment to augment banks' capacity to make term loans by ongoing reductions in bank reserve asset ratios. The nature and extent of banks' involvement in term lending should be a matter for their commercial judgment. The Committee understands that this is the way banks' involvement in term lending is currently being determined, and it believes this should continue.

39.50 A relatively unfettered commercial banking system, including PIBA, would seem to render the requirement of separately constituted TLF (rural finance)/FDLF arrangements redundant.

39.51 The Committee ***recommends*** that, **as soon as reasonably practicable, the monetary authorities should cease to be formally associated with the banks' provision of longer term loan funds through the Term and Farm Development Loan Funds; thereafter whether these funds would continue to be separately maintained should be at the discretion of individual banks.**

(c) Commonwealth Development Bank/Primary Industry Bank of Australia

39.52 The Commonwealth Government is directly involved in the ownership and operation of two specialist banks serving primary industry — the Commonwealth Development Bank (CDB) and the Primary Industry Bank of Australia (PIBA).

39.53 The CDB is discussed in Chapter 28. In essence the Committee believes that the deregulated financial environment it proposes will ultimately develop to the stage where there is no long-term, continuing need for a separately instituted commercial lender of last recourse such as the CDB. Nor is the CDB viewed as the most cost-effective channel of government assistance. The Committee has

accordingly proposed that in due course the CDB be formally absorbed within the Commonwealth Trading Bank.

39.54 The CDB has traditionally had a special involvement with the rural sector and has a special capacity in this area of its lending. For reasons explained in Chapter 28, the Committee does not expect that under its proposals this expertise will be lost from the finance industry.

39.55 In reaching this conclusion the Committee makes no judgment on whether governments should assist rural and other primary industry borrowers, with regard to either the volume or cost of loans. The concern primarily is to seek arrangements which are both efficient and entail minimum distortion to the incentive of commercial lenders to undertake this business. Assistance objectives can be achieved in various ways including direct help to borrowers or through arrangements such as exist with PIBA.

39.56 As it is presently structured and operated PIBA is a hybrid of a private commercial financial institution and a government financial institution which is non-commercial in its orientation. Consistent with the Committee's general approach to these matters there is much to be said for restructuring PIBA to make it a more commercially orientated enterprise even though it may retain a role in the disbursement of government assistance to long-term rural borrowers.

39.57 Particular focal points of the Committee's attention are the Government's involvement in the ownership, management, policy and funding of PIBA.

39.58 In respect of **ownership**, the Committee can see no strong economic reason why the Commonwealth should continue to be a direct shareholder in PIBA (particularly not in addition to the indirect ownership it holds through the Commonwealth Trading Bank). The Committee is not attracted to the concept of mixed (private and government sector) equity partnerships in basically commercial financial enterprises (see Chapter 26).

39.59 In respect of **management** and **policy** the Committee notes that:

- apart from the Government, as a shareholder, being entitled to appoint a director, the Treasurer also appoints the Chairman and two other directors to represent primary producer interests;
- there is provision in the legislation for the Treasurer to be informed of, and, at his discretion, consulted about the Bank's policies.

The Committee would prefer that the Government not be involved directly in the commercial operations of PIBA. Given, however, that the institution may be a particular vehicle for the ongoing distribution of government subsidies, Government should retain the capacity to satisfy itself by other means that the disbursement of government funds is in accordance with its requirements. This could be accomplished by making PIBA subject to regular review — e.g. by the Auditor-General.

39.60 The present arrangements for **funding** the lending operations of PIBA are, by the Committee's tests (see Chapter 36), unsatisfactory. PIBA's borrowings consist mainly of deposit funds raised in commercial markets, supplemented by subordinated loans from prime lenders and low-cost loan funds from the Government (mainly funded from Income Equalisation Deposits). These arrangements are not fully consistent with the Committee's preferred standards of **visibility, disclosure** and **accountability**. It can see an advantage for any subsidy

flowing to PIBA to take the form of a specific annual grant from the Budget to achieve whatever level of assistance is desired. This fiscal subsidy would cover the cost of the concessional credit provided by PIBA. In other respects PIBA would be a commercial operation.

39.61 If a subsidy is provided to PIBA, it would be important to carry out regular evaluations of PIBA's role and operations to ensure that it offered the most cost-effective vehicle through which to transmit government assistance to primary industry borrowers, especially in the less regulated environment envisaged by the Committee. In that evaluation, the authorities should have regard for considerations of competitive neutrality.

39.62 Of course, the continued existence of PIBA would, at all times, be a matter for the commercial judgment of existing and potential shareholders.

39.63 The Committee ***recommends*** that:

(a) **The Government should dispose of its direct shareholding in the Primary Industry Bank of Australia (PIBA).**

(b) **The Government should stand aside from the commercial operations of PIBA. Alternative arrangements should be established to monitor the disbursement of any government funds through the agency of the Bank.**

(c) **Government subsidisation, if any, of the cost of long-term loans made to primary producers and refinanced by PIBA should be effected by the provision of recurrent Budget allocations.**

(d) **The role and operations of PIBA as a vehicle of sectoral assistance should be kept under regular review.**

D. SEASONAL MARKETING FINANCE ARRANGEMENTS

39.64 The question of the Reserve Bank's involvement in the provision of a seasonal marketing finance facility to rural producers through its Rural Credits Department was discussed previously, in Chapters 2 and 6, in the context of the role of the Reserve Bank and seasonal fluctuations in liquidity. The focus here is on the use of this mechanism to deliver subsidies to eligible rural produce marketing authorities.

39.65 While the Committee recognises that rural producers and their marketing authorities may need access to credit ahead of sale, it is not persuaded that the current arrangements are ideal. It can envisage alternative means of meeting this demand which, though just as effective, would not have the same undesirable features.

39.66 Present arrangements may involve delivery of a price subsidy which is greatest in value when farm incomes are highest and which is generally arbitrary in its overall incidence. In terms of many economic and welfare criteria, a strong case could be made for extending any subsidy only on a basis consistent with maintaining income flows. Moreover:

(i) as previously discussed:

- a sectoral commercial lending function is not appropriate for the central bank when the private commercial financial system is able to meet the demand;

- outflows of cash from the Reserve Bank add to the liquidity base of the private sector; although in this context relatively unimportant, in overall terms RCD credit flows have typically accentuated underlying seasonal volatility in the liquidity base; and

(ii) while the Committee takes no position on the question of subsidies to assist rural produce marketing operations, it is concerned that the subsidy under present RCD arrangements is not clearly visible and that there is no evidence that its size is subjected to careful assessment in terms of economic and welfare considerations;

39.67 The Committee ***recommends*** that **the Rural Credits Department of the Reserve Bank should be phased out, with appropriate transitional provisions which have regard for the need of existing customers to make alternative arrangements.**

39.68 The Committee notes that recently the Wheat Board has been meeting a substantial part of its marketing finance needs by issuing commercial paper on the open market without any particular problems; the Board is reimbursed by direct budget grants, to the extent deemed appropriate by government, for the additional costs incurred over those which would have been payable to the RCD.

39.69 Such arrangements are preferable in most respects. As far as **availability** of finance is concerned, they use the established commercial facilities and avoid the compounding of undesirable seasonal effects on the liquidity base of the financial system. As far as the **cost** of finance is concerned, the subsidy is visible and can be varied at the government's discretion.

39.70 The Committee envisages that the other function of the RCD — the provision of grants to organisations engaged in rural research and promotion — would also more appropriately be funded from the Commonwealth Budget. It is not clear that the administration of such arrangements should remain with the Reserve Bank. If the recommendation to phase out the RCD were accepted, appropriate transitional arrangements would need to be made for the funding of ongoing research.

CHAPTER 40: EXPORTS

A. BACKGROUND

40.1 The provision of finance to exporters and/or their customers from Australian sources is at present largely in the hands of the trading banks, the Australian Banks' Export Refinance Corporation (ABERC), and the Export Finance and Insurance Corporation (EFIC). Other providers of funds include merchant banks, finance companies and confirming houses.

40.2 Trading banks are the major suppliers of export credit and offer a wide range of financing facilities. The bulk of their trade credit financing activities involves transactions with settlement periods of six months or less. About 80% of Australia's exports are sold for cash or settlement within 180 days.

40.3 For medium and longer term export finance, banks may obtain assistance from their jointly owned affiliate, ABERC. It may refinance banks for transactions involving credit terms longer than twelve months and has approved facilities for terms up to ten years. The Corporation, now part of the Australian Resources Development Bank, was established in 1964 and, while remaining small, is providing a growing proportion of finance for capital goods exports.

40.4 The government-owned EFIC, originally established in 1956 as the Export Payments Insurance Corporation, is also involved in the provision of export credit. Where overseas importers of capital goods have access to subsidised finance, EFIC will match this by lending directly to the overseas buyer up to 85% of the Australian content of the contract value. Funds are borrowed by EFIC from the trading banks at commercial rates of interest and on-lent at concessional rates. The gap between EFIC's borrowing rate and the subsidised lending rate is financed from the Budget.

40.5 At 30 June 1981 EFIC had entered into loans in support of capital goods exports amounting to almost $300 million. The extent of the potential direct subsidy is clearly stated in a 'subsidy commitment authority' (currently $60 million) which is determined annually in the Budget. Actual subsidy expenditure each year is only a small proportion of this authority. In 1979–80, and 1980–81 it was $2.6 million and $4.7 million respectively and the budget estimate for 1981–82 is $9 million.[1]

1 EFIC has also entered into a special commitment in respect of the procurement of capital goods from Australia for the OK Tedi Project (a gold and copper mine in Papua New Guinea). Credit lines totalling $212 million have been offered and a separate subsidy commitment authority, of $73 million, established; the estimated subsidy payment in 1981–82 is $1.7 million (included in the estimated overall subsidy of $9 million).

40.6 Certain forms of concessional export financing and related facilities are provided by the overseas equivalents of EFIC, and collectively government intervention in these processes is seen largely as a defensive measure to protect the competitive position of their exporters in world markets.

40.7 Because of the danger of a 'credit selling race' between EFIC and its overseas counterparts, several international agreements have set minimum interest rates and maximum credit periods for the financing of capital goods exports. The effectiveness of these agreements varies.

40.8 EFIC also offers to guarantee certain loans extended directly to an overseas **buyer/borrower**, by an Australian lending institution, to finance the purchase of capital goods and associated services which are wholly or mainly produced in Australia and where payment is appropriately spread over two years or more. The unconditonal guarantee is provided to the lender without recourse to the exporter, the effect being to enable the exporter to make a cash sale without any contingent liability in connection with the loan.

40.9 As well, EFIC provides a range of export payment insurance and guarantee facilities.

40.10 Export payments insurance has special characteristics. The normal commercial risk — i.e. the failure of the buyer to pay, either because he becomes bankrupt or because he is untrustworthy — applies equally whether goods are supplied for export or the domestic market. However, the collection of bad debts from a buyer in a foreign country, where there may be different standards of commercial and legal practices from Australia, creates special difficulties.

40.11 In particular, there are economic and political risks which are absent from domestic trading. These include:

- inability or unwillingness of the authorities in the overseas country to transfer the necessary foreign exchange to Australia even though the overseas buyer may have discharged his debt by paying the appropriate amount of local currency into the banking system;
- the cancellation of an import licence; and
- disruption to the flow of trade and payments due to war, civil disturbance or political upheaval.

40.12 To the extent that political and some commercial risks do not lend themselves to meaningful assessment they are not easily insurable on the private commercial market. This is recognised overseas where all the members of the International Union of Credit and Investment Insurers, which provides a comprehensive export credit insurance facility for their exporters, rely on government support in one form or another.

40.13 EFIC insures all categories of export payments covering 90 to 95% of the otherwise uncovered risk. Banks can provide finance on the security of the insurance contract. In effect, EFIC undertakes to guarantee payment to the exporter and this may assist him in obtaining finance. The exporter is insured for commercial and non-commercial risks within the terms of the policy and to the extent of the indemnity provided therein.

40.14 In addition EFIC offers:

- insurance to Australian banks which are asked to confirm letters of credit opened by overseas banks to support finance for export transactions; and

- unconditional guarantees to lending institutions providing **supplier** credit where an EFIC policy is assigned by an exporter as security for the loan; the lender finances the exporter without recourse and the exporter pays a further small premium as well as entering into an agreement to reimburse EFIC, where the cause of non-payment by the buyer is not covered by the underlying EFIC policy of insurance.

40.15 A fuller description of existing export financing facilities is to be found in paragraphs 21.114–123 and Appendix 12 of the Interim Report.

B. ISSUES

40.16 Export financing did not feature prominently as an issue in submissions to the Committee. Indeed, most of the submissions put to the Committee appeared to agree that the financial needs of exporters are being generally met by existing institutions. Nonetheless, views were expressed that:

- there is a need to promote greater competition in the provision of export finance and related services;
- certain forms of pre-shipment finance are inadequately catered for at present;
- export incentive schemes could be improved; and
- EFIC's role in providing concessional finance and buyer credit guarantees for the benefit of the export sector is unduly restricted in terms of the range of activities covered; in particular, it should be extended to pre-shipment finance and consumer goods exports.

(a) Competition

40.17 The view has been put to the Committee that exporters would particularly benefit from greater competition in the provision of finance and related services. Greater participation by foreign banks is seen as a useful step in this direction. The anticipated benefits include:

- enhanced access and more competitive terms and conditions;
- the ability to deal with the same bank locally and overseas where it is servicing both parties to a transaction through its international branch system;
- lower costs through the economies obtained from using standard issuing, documenting and payment procedures within a single international banking organisation;
- speedier issue, clearance and payment of trade documents;
- easier access to a wider range of financing facilities including multi-currency loans, US bankers' acceptances, euro-currency loans and international credit facilities at all of the banking group's offices; and
- extensive trade development facilities through a wide-ranging international branch network located in all of Australia's existing export markets.

40.18 The Australian banks claim that by the extensive use of correspondent relationships with overseas banks, combined with the use of the latest electronic funds transfer systems for overseas payments, their trade financing services are more extensive than those of individual foreign banks relying on their own branch networks. The foreign banks in turn point out that the quality of the Australian banks' service is dependent on the service provided to them by correspondent banks.

40.19 The Committee's main concern is that, given the importance of international trade to Australia, there should be strong market incentives to adopt the most efficient trade financing techniques. Such incentives would be most likely to exist if foreign banks were allowed to participate directly in providing trade finance (see Chapter 25).

(b) Pre-shipment and Plant Finance

40.20 It has been put to the Committee that difficulties have been experienced in obtaining forms of pre-shipment finance, particularly plant finance, to meet new or increased export orders.

40.21 The Committee is not convinced that pre-shipment export finance or finance for export plant is essentially different from ordinary working capital or general production finance. The critical feature of the argument appears to be that the opening up of export markets requires a sizeable leap in production levels and plant capacity for many small and medium-sized manufacturers. However, 'leaps' in size may equally emanate from domestic sources; and although such 'leaps' are likely to be less frequent or marked, they would present similar problems.

40.22 In many instances the 'non-availability' of the required funds reflects a judgment as to the creditworthiness of the proposal.

40.23 To the extent that there are market imperfections in this area the Committee believes they are again largely a manifestation of the distortions caused by current controls and regulations, e.g. bank interest rate controls, captive market provisions, and barriers to entry.

(c) Export Incentive Schemes

40.24 The Committee accepts that trading across international boundaries gives rise to some considerations that do not exist in domestic business transactions. The special needs of exporters are recognised in the range of government export incentive schemes available, such as the provision of grants for export performance and reimbursement of market development expenditure. However, it has been put to the Committee that these are not immediately effective as a means of assisting exporters' cash flow because the time lag between expenditure and government rebate often amounts to two to three years — sometimes even longer.

40.25 While recognising this problem the Committee sees any scheme which attempts to subsidise exporters on the basis of anticipated exports as being too difficult to administer and potentially open-ended. If, for example, the criterion for receiving a grant were the receipt of a firm documentary letter of credit, this would be no guarantee that the exporter would be able to meet future commitments to supply the goods. There appears to be no practical alternative to current schemes based on past export performance or past expenditure. While it has not been possible to determine the extent of all delays in the reimbursement from government export incentive schemes, it seems that adequately documented claims presented promptly at the beginning of the financial year are subject to delays in payment of up to six or seven months. The Committee believes the Government should pin-point and, where possible, reduce any delays in providing funds under existing schemes.

(d) Eligibility for Concessional Export Finance

40.26 Against this background, the Committee is not attracted to suggestions that the range of activities eligible for concessional finance should be extended. In

particular, it examined the proposal that loans should be made to exporters at **concessional** interest rates to assist in the **pre-shipment** phase (including plant construction) and that the loans could be distributed through the banking system (and subsidised by EFIC) by setting aside a percentage of Statutory Reserve Deposits for export development.[2]

40.27 It is significant that only a relatively small number of overseas governments seek to financially assist exporters in the matter of pre-shipment finance (mainly through guarantees). It is also worth noting that the New Zealand Government introduced a 'last recourse' pre-shipment finance scheme for small exporters in February 1978 and that as yet exporters have shown little or no interest in that scheme.

40.28 In the Committee's view the case for concessional pre-shipment finance facilities has not been established. If the Government were to provide assistance in this area it would run the risk of simply propping up marginal exporters whose talents and resources might better be utilised in other areas. Biasing the course of development of Australian business towards exporting and away from production for local markets by means of concessional finance can lead to inefficiencies in both financial and goods markets; it is also not the most efficient means of handling any problems that might be seen to exist in the balance of payments.

40.29 Suggestions have also been made to the Committee that concessional finance be provided for **consumer goods exports.**

40.30 At present, concessional finance is available through EFIC but only to buyers of Australian capital goods exports.

40.31 The provision of export finance was formally referred to the Committee by the Crawford Committee Study Group on Structural Adjustment. In the view of that Committee:

> . . . small and medium-sized firms would be in a better position to export if they had better access to export finance . . .There appear to be situations in which small and medium-sized firms are deterred from entering export markets or from increasing export sales because of perceived difficulities in providing extended credit to overseas purchasers of their products. Although the Export Finance and Insurance Corporation (EFIC) now provides finance at subsidised interest rates, this is limited to finance for exports of capital goods. There appears to be a case for investigating the availability of finance for exports of other goods, particularly in the case of small and medium-sized firms.[3]

40.32 The Committee's attention has also been drawn to the fact that some overseas consumer goods producers competing with Australian exporters qualify for export finance on special terms in respect of consumer goods contracts. In the United Kingdom for instance, banks may obtain on behalf of exporters an unconditional guarantee from Export Credits Guarantee Department (EFIC's counterpart), which supports the provision of consumer goods export finance at an appropriately 'low' rate of interest. Unlike the provision of finance on concessional

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2 As noted in another context (paragraph 39.47) the Committee is opposed to the use of Statutory Reserve Deposits to fund special purpose loans.

3 Crawford Committee Study Group on Structural Adjustment, 1979, Vol. 1, Chapter 13, p. 10.

terms to buyers of capital goods exports, no direct cash subsidy is involved in these schemes unless the insurance operation is conducted at a loss.[4]

40.33 As the Committee understands it, the general practice overseas is **not** to directly provide government finance on concessional terms for exports of consumer goods, although arrangements such as those in the UK provide indirect assistance.

40.34 Given the different degrees of integration of 'special' export financing facilities, the Committee has not been able to clearly determine how the export credit facilities available to overseas suppliers and buyers of consumer goods exports compare with those in Australia.

40.35 The Committee believes that export finance subsidies can unintentionally distort overall market processes but appreciates governments' concern to ensure that finance to domestic exporters is available on terms and conditions comparable with those available elsewhere.

40.36 The Committee therefore ***recommends*** that:

(a) **Every effort should be made by the Government and the Export Finance and Insurance Corporation to limit the use of concessional export finance facilities here and abroad.**

(b) **Unless it can be clearly demonstrated that in other countries the buyers of consumer goods exports are financed on more favourable terms than in Australia, the existing concessional finance scheme should continue to be limited to capital goods exports.**

(c) **Unless the Government is satisfied that similar schemes are generally offered overseas and material export contracts are being lost due to lack of matching support, facilities for buyer credit guarantees should not be extended to all exports.**

C. ROLE OF EXPORT FINANCE AND INSURANCE CORPORATION

40.37 EFIC has a general charter to encourage international trade and commerce by developing and expanding its business. Through government ownership it provides specialised facilities not normally obtainable in commercial markets. In Chapter 26 the Committee recorded certain principles regarding the **commercial operations** of such institutions.

40.38 To the extent that EFIC's services are provided on other than fully commercial terms it is a **vehicle for sectoral assistance.** The principles which the Committee considers should govern the provision of sectoral assistance are recorded in Chapter 36.

40.39 It is important to consider EFIC having regard for the sets of principles in Chapters 26 and 36.

40.40 It must be recognised that EFIC operates in a unique market environment. The participation of EFIC (and its counterpart institutions in other countries) may,

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4 Another important difference between overseas schemes for exports of capital goods and those for exports of consumer goods is that in the case of the former the concession applies to the **overseas buyer** whereas for consumer goods the arrangements apply to **domestic suppliers.**

for example, yield important economic externalities in respect of Australia's export performance and world trade more generally.

40.41 Usage of EFIC's direct lending and related buyer credit guarantee facilities is confined to situations where there is a clear **market gap** in the financing options open to Australian exporters. These facilities are partly, if not solely, a response to the actions of other governments and can best be provided through a government-owned institution.

40.42 Similarly, EFIC's export payments insurance and associated operations offer protection for Australia's international trade and commerce against both political, non-commercial risks and commercial risks of default by overseas importers. The Committee is satisfied that here too EFIC **fills a market gap**; it can fulfil these functions more effectively because it is owned by government.

40.43 Moreover, there would not appear to be a more cost-effective way of securing the associated externalities or responding to the international market imperfection. It is unlikely that EFIC is pre-emptive of viable private financial enterprises in Australia performing the same function.

40.44 To the extent EFIC seeks to provide insurance and guarantees on a fully commercial basis these operations should be distinguished in its accounts from any business done on a **non-commercial** basis.

40.45 It would appear that these facilities (including buyer credit guarantees) are not in general priced on a fully commercial basis. The Government apparently believes that current pricing policy is consistent with matching the international market, obtaining beneficial externalities and encouraging growth of Australia's international trade and commerce. If the total costs incurred by EFIC were recovered in the premiums charged, and a level of profit earned which was fully commensurate with the commitment of government resources,[5] the objectives of beneficial externalities may not be achieved. The Committee does not express any judgments in these matters.

40.46 The Committee's concern relates only to the adequate disclosure of the true and total cost to the Government of the facilities. Accordingly, it suggests that the accounts should note any shortfall in achieved premiums and, whenever possible, the total cost of government assistance.

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5 Some guidelines were suggested in Chapter 26.