Ai GROUP SUBMISSION

Ai GROUP SUBMISSION TO SENATE ECONOMICS COMMITTEE: INQUIRY INTO ACCESS OF SMALL BUSINESS TO FINANCE

AUSTRALIAN INDUSTRY GROUP

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Ai Group Submission to Senate Economics Committee: Inquiry into Access of Small Business to Finance

Availability of Credit – Background

Credit availability in both Australia and overseas has tightened primarily because of the increase in risk premia experienced in financial markets in the aftermath of the sub-prime mortgage market crisis and its coda, the collapse of Lehman Brothers in September 2008.

The worst of the problem was experienced in overseas financial markets, particularly in the US, Europe and UK. Increased aversion to risk by overseas financial institutions initially meant a lack of willingness of hitherto relatively 'riskless' banks to lend between themselves in short-term money markets.

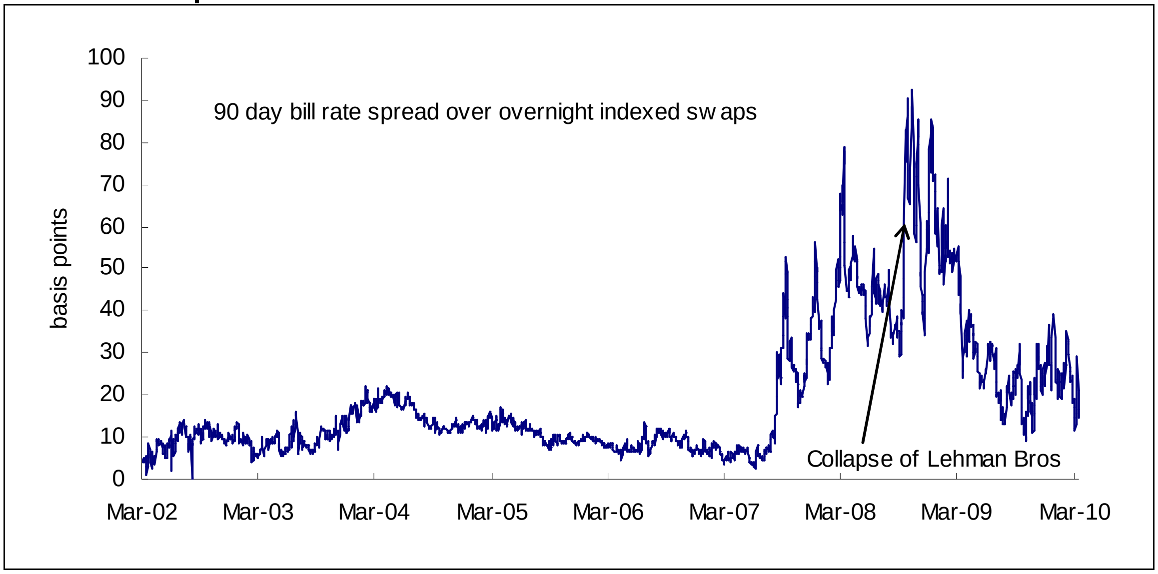
Further down the credit line, this was reflected in a significant increase in the credit standards being applied to 'riskier' borrowers such as smaller businesses, potential home mortgagees and consumers. The riskier the borrower was perceived to be, for example small business and firms exposed to the global economy, the increasingly more difficult it was for borrowers to obtain finance for investment and/or working capital.

Various policy measures, including bank bailouts and part-nationalisations, had an impact in averting a collapse of the global financial system but the consequences of the global financial crisis are still seen in the slow recoveries being experienced in the economies most affected, including the United States, Europe and the United Kingdom.

In the Australian case, the problems affecting inter bank lending were significantly less severe than overseas given the relatively low exposure to falling asset prices and therefore deterioration in bank balance sheets. Government guarantees of bank deposits also assisted in stemming the potential for loss of confidence in the local financial sector.

As Chart 1 illustrates, though risk premia rose significantly in the wake of the collapse of Lehman's, they have eased significantly since early 2009. Notwithstanding this, and in part reflecting global concerns around European public debt levels, local premia remain elevated in comparison to the pre-GFC period.

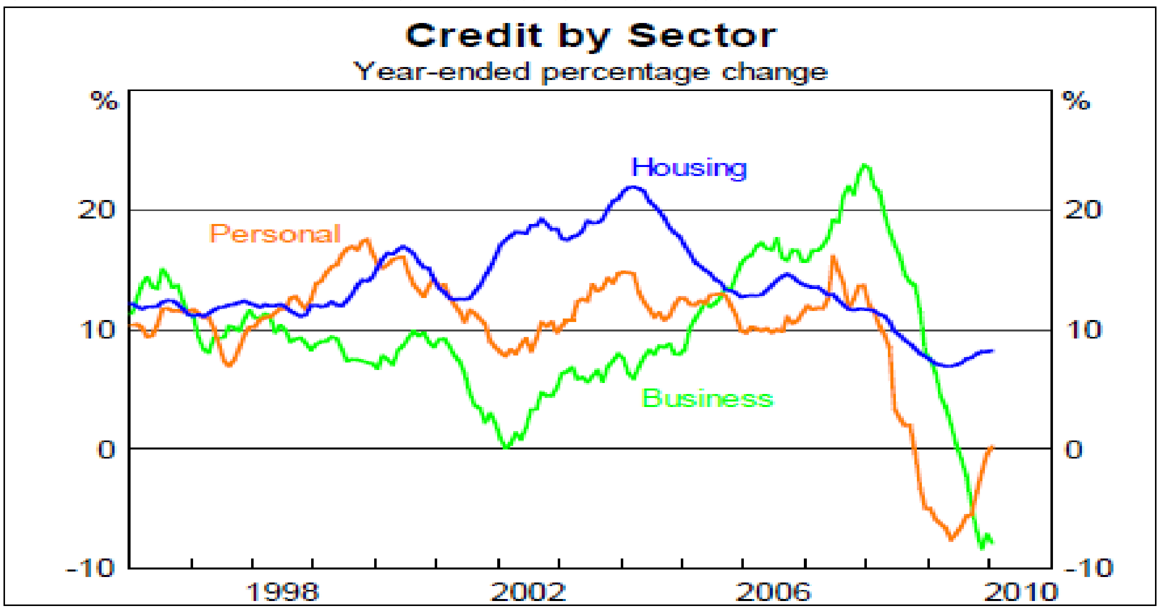
Chart 1: Risk premia have eased but remain elevated



Source: Reserve Bank of Australia (RBA)

Business demand for finance, despite an improvement in domestic economic growth, remains weak (Chart 2).

Chart 2: Business demand for finance continues to fall



Source: RBA

Reserve Bank of Australia and Commercial Bank Evidence on Credit Availability

Evidence from the Reserve Bank of Australia (RBA) and commercial banks suggests that credit availability is an important issue for some businesses, particularly for small and medium enterprises (SMEs) that have a narrower range of finance options.

The flow through of higher risk premia in financial institutions lending was reflected in the RBA's business liaison, as reported in the Bank's February 2009 Statement on Monetary

Policy. Business liaison indicated that financing conditions were becoming more difficult during 2008 for firms <u>across a wide range of industries</u>.

More recently, in the RBA's Financial Stability Review for September 2009, the Bank noted that:

- "Difficulties in credit markets appear to be easing somewhat, and funds have generally been available for good quality borrowers. Borrowing conditions, however, remain tighter than in recent years".

The Bank also highlighted that while certain sectors had been harder hit, given declines in investment plans, firms had generally focused on rebuilding balance sheets.

- "While financial stresses have increased in some areas, particularly for commercial property, firms across the business sector have actively consolidated their balance sheets over the past six months."

In addition other sources of finance were filling some of the gaps, particularly equity finance.

- "Listed companies have been able to raise a record amount of equity capital; investors have supported this issuance, as share prices have recovered somewhat and confidence about business prospects has improved."

This reinforces comments the Reserve Bank Governor made in his appearance before the House of Representatives Standing Committee on Economics on 19 February 2010:

- "We have taken careful note also of non-price credit conditions. For large firms, access to capital market funding, both debt and equity, has been good. For some other business borrowers, access to credit has remained difficult, though we are seeing suggestions in our liaison now that this may be starting to ease. Furthermore, it appears that the rate at which lenders are having to make provisions for bad loans has slowed noticeably, which is not surprising, given that economic conditions have been improving."

Most recently in the RBA's Financial Stability Review for March 2010, the Bank indicated:

- "While economic conditions are now improving, firms continue to report above-average difficulty in obtaining finance, though this too appears to be easing".

In addition, the RBA stated:

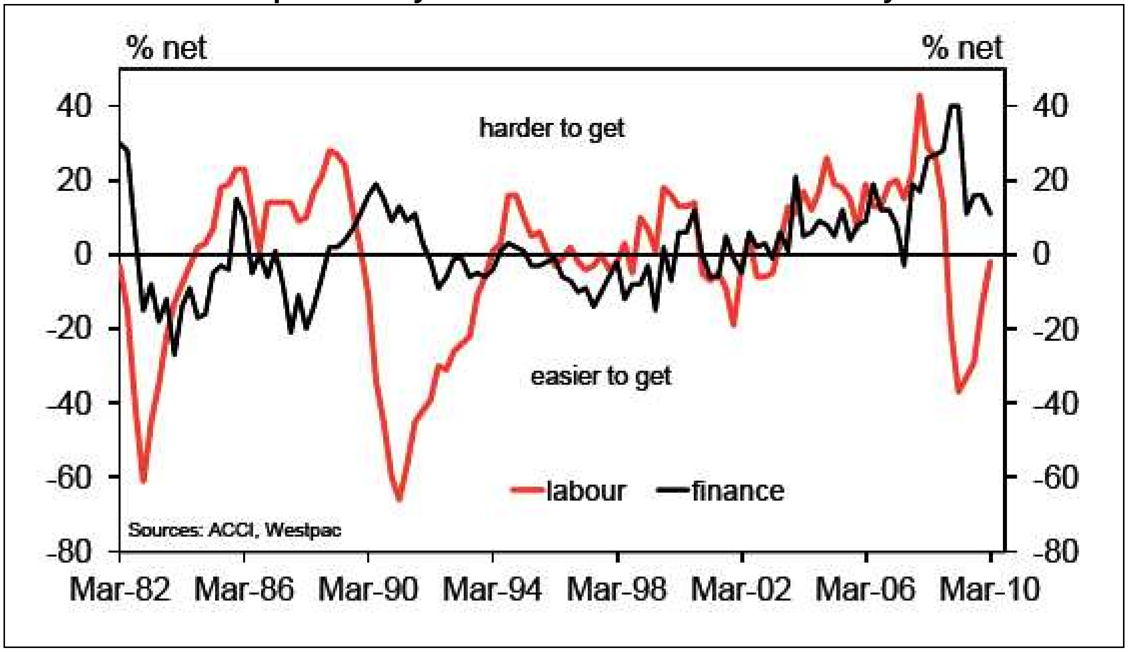
- "On the supply side, banks have also tightened the terms and conditions under which they are willing to extend credit to businesses and households".

Westpac

Westpac reported in its survey of industrial trends in manufacturing (carried out with ACCI in February-March 2010) that "financial conditions eased moderately with the net balance of respondents reporting finance as 'harder to get' down to 11% from 16%, near its decade average (10%) and well below its (March quarter 2009) peak of 40%."

This improvement is in line with the RBA's view that access to finance for has become easier in an economy wide sense in recent months.

Chart 3: ACCI/Westpac Survey of Industrial Trends – Availability of Finance



Source: ACCI/Westpac Survey of Industrial Trends, December quarter 2008

Furthermore, it appears that access to finance is a relatively small order issue in terms of the factors limiting production, compared in particular, to the level of new orders.

Table 1: ACCI/Westpac Survey of Industrial Trends – Key Factors Limiting Production

	Q3 2009	Q4 2009	Q1 2010
Orders (%)	60	67	62
Capacity (%)	12	6	7
Labour (%)	2	3	4
Finance (%)	3	2	5
Materials (%)	3	2	0
None (%)	9	9	11
Other (%)	11	11	11

Source: ACCI/Westpac Survey of Industrial Trends, December quarter 2008

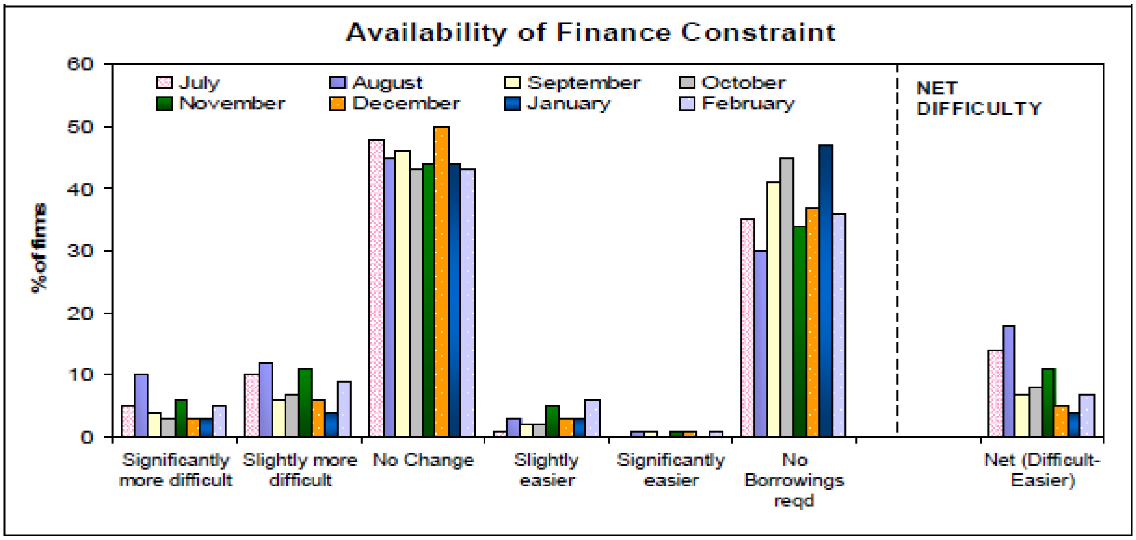
National Australia Bank (NAB)

The NAB conducts a monthly survey of business conditions that covers the economy across the broad range of sectors, compared to the ACCI/Westpac survey, which covers only manufacturing. In the wake of the global financial crisis NAB introduced a new question into its monthly business surveys on how business views the availability of credit. The NAB Survey for February 2010 reported that the Reserve Bank has observed signs that business de-leveraging may be moderating and consequently that a turning point in demand for finance may be approaching.

In line with this, NAB's February Survey, as shown by Chart 4 (though the data are not seasonally adjusted) revealed a fall in the share of businesses not requiring borrowings.

At the same time, there was a slight rise in the index reporting net difficulty in obtaining credit (up 3 points to +7 points). However, over the past six months there has been a noticeable reduction in the difficulty in obtaining finance.

Chart 4: NAB Monthly Business Survey February 2010 – Availability of Finance



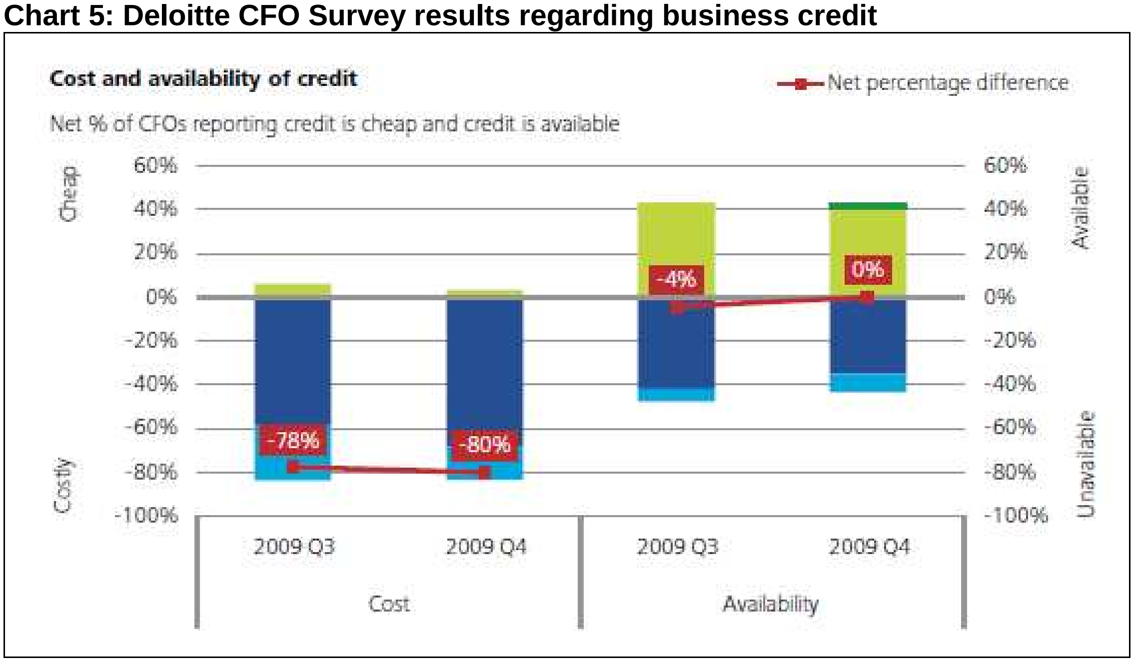
Source: National Australia Bank – Survey of Business Conditions February 2010

Other evidence

Deloitte CFO Survey

The Deloitte CFO Survey for 2009 Q4 suggests that the cost of credit is a major issue for most CFOs surveyed. Chart 5 shows that approximately 80% of CFO surveyed indicated that credit is costly. Chart 5 also shows there is some polarisation of views with respect to availability of credit –approximately an even split in CFO views regarding availability.

Chart 5: Deloitte CFO Survey results regarding business credit



Source: Deloitte CFO Survey for 2009 Q4

Small Business Access to Finance

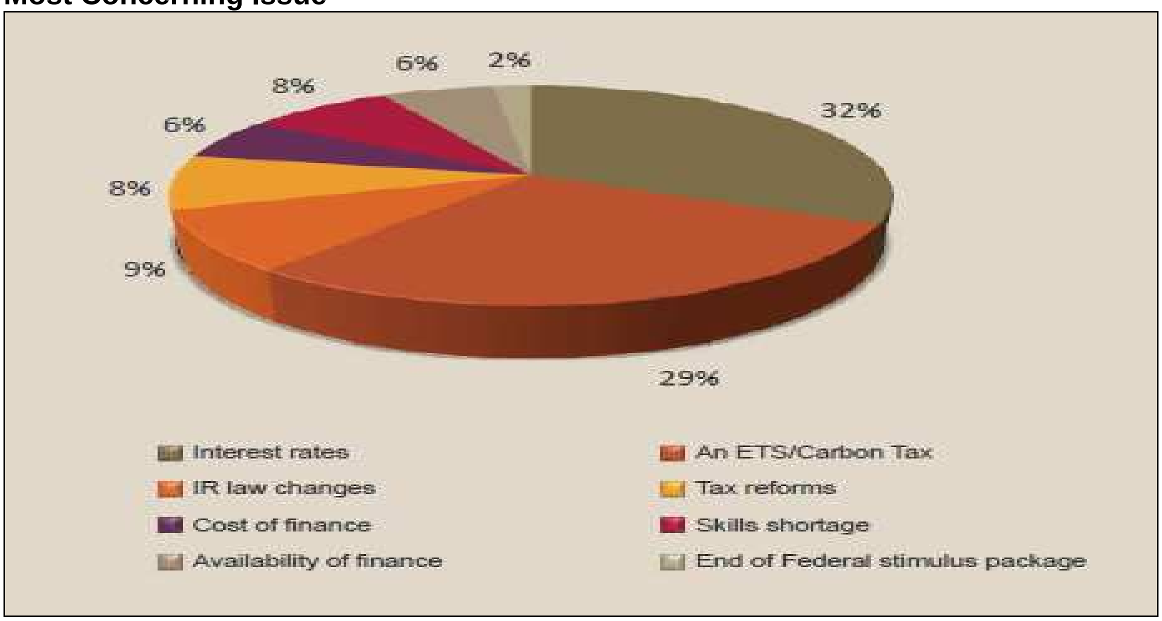
There is little time series evidence available on developments in small business access to finance. However, two relatively recent surveys indicate that small business regard access to finance, when taken together with the impact of higher interest rates, as an important concern (Table 2 and Chart 6).

Table 2: Telstra/Council of Small Business Back to Business Survey 2010 – Concerns for SMEs in 2010

	Possible ETS/ carbon tax	Tax reforms	Availability of finance	Cost of finance	End of Federal financial stimulus	Higher interest rates	Changes to IR laws	Skills shortage
Very concerned	**42%**	**32%**	**23%**	**37%**	**16%**	**50%**	**32%**	**27%**
	128	97	70	114	48	153	98	83
Somewhat concerned	**29%**	**42%**	**41%**	**37%**	**36%**	**31%**	**35%**	**39%**
	88	130	126	115	110	95	106	119
Not concerned	**23%**	**17%**	**33%**	**21%**	**44%**	**15%**	**27%**	**30%**
	70	52	101	65	135	47	84	92
Don't know	**7%**	**9%**	**3%**	**4%**	**5%**	**4%**	**6%**	4%
	21	28	10	13	14	12	19	13

Source: Telstra/Council of Small Business Back to Business Survey 2010 - SME financial outlook, main concerns and attitudes to technology

Chart 6: Telstra/Council of Small Business Back to Business Survey 2010 – Single Most Concerning Issue



Source: Telstra/Council of Small Business Back to Business Survey 2010 - SME financial outlook, main concerns and attitudes to technology.

Less recently, in March 2009, a survey[1] of 500 Victorian businesses on business finance and investment, found that, over the previous six months, access to capital had been

[1] Source: VECCI

compromised. Thirty per cent of respondents indicated that availability of capital was the key barrier to investment, while 17 per cent cited the cost of capital.

This result is unsurprising given that the survey was undertaken in close proximity to the peak of concerns around the global and domestic impacts of the financial crisis in the aftermath of the collapse of Lehman Brothers.

Ai Group Evidence on Access to Finance Issues

Ai Group's direct consultation with businesses through advisory services has identified the following issues related to access to finance, particularly for small businesses.

1. The cost of finance

Whilst home loan interest rates were reduced during the GFC, interest rates to business have not fallen significantly and typically resemble personal finance rates. This has placed additional pressure on small business during a difficult operating period. There has been little incentive for businesses to improve their risk profile via better management, with the view that the banks only look at asset backing to determine the interest rate.

2. Tightened lending practices

A number of firms are having serious difficulties due to the banks and financial institutions tightening up their lending practices. This has often been done with no prior notice.

- Example 1: A client firm builds semi-trailers for the heavy transport industry. In the past the firm has used finance to start each job (order). This finance is expensive but it enables the SME to buy the materials and parts required to do the job and helps with cash flow. Then the purchaser borrows money from a bank or financial institution to pay for the finished product when it is delivered some 10 – 12 weeks later. In the past, applying for the loan was done a few weeks before delivery. So the trailer manufacturer is carrying the loan during the building of the trailer.

- Now the firm is finding banks have tightened up lending, with some loans not being approved as quickly and in some cases not at all. This means the trailer builder at best has to pay interest on his loan for a longer period which erodes his profit. At worst, if the customer's bank does not approve the loan at all, the trailer manufacturer ends up with a custom-built trailer he cannot sell and is paying interest on.

- Example 2: A client firm builds stainless steel wine storage tanks. Workload has dropped enough for the firm to have to lay off seven people out of 48. The owner's explanation is that wineries no longer have access to finance to expand their businesses so they have stopped purchasing new and replacement equipment. In his view it is because the banks have tightened up their risk assessing practices and are not lending as they have in the past. This causes him some difficulties as he has to buy stainless steel on the world market at varying exchange rates. Therefore he has to buy well in advance of getting orders but then he has to carry the stock due to lack of sales

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3. Lack of financial skills, advice and management

This is an important underlying factor that impacts on the need for access to finance. Ai Group business advisers often find that small business clients do not understand and cannot interpret their business financials. As a result, financial considerations often only emerge when cash is running short and this can be too late.

Many of the Ai Group's business advisers' lower turnover clients receive very little or nothing in the way of financial advice from their chartered accountants. Many small firms are under capitalised, the owner cannot see that this is the case and their chartered accounts do not assist. Chartered accountants tend to focus on tax and compliance issues, and see their job as technical and not advisory. Clients also see accountants as expensive and only give them the narrowest of briefs, in order to mitigate costs.

4. Choice of finance options – competition in the market for SME lending

Most small business clients depend upon bank finance to operate via an overdraft facility. Stable relationships are highly valued with banking staff. Furthermore, if additional business assets are required, leasing and hire purchase are commonly used, indicating banks are not always regarded as the preferred source of finance. This suggests that a broader issue in relation to access to credit, over and above the impact of current economic conditions on lending, is the structure and degree of competition in the market for lending to SMEs.

Is Lack of Credit a Constraint on Economic Activity?

The data on credit availability has generally become more positive. RBA liaison, the NAB Survey (despite February's result) and the ACCI/Westpac manufacturing survey appear to suggest that credit availability has become easier in recent months.

At the same time, one of the key determinants of finance demand, the investment outlook, appears to be improving. ABS private new capital spending data for December quarter 2010 showed a 5.5% lift in investment in the quarter. More importantly business expectations for investment in 2010-11 are consistent with a rise of around 5-10% - roughly in line with current Mid-Year Economic and Fiscal Outlook government forecasts of a rise of 5.5% in the same period.

That general access to finance appears to be improving at a time when the outlook for finance demand is lifting suggests overall finance supply is not as important a constraint on economic growth as it was during the early months following the global financial crisis.

However, while access to borrowings and equity raisings have improved recently and are expected to improve further over the coming year, those firms in sectors seen as relatively high risk, including apartment building and small business, generally are likely to see access to finance improve relatively more slowly given still elevated financial market risk premia.

In addition, tight business credit affordability and availability is also more likely to adversely affect small businesses. This is because smaller businesses are more dependent on bank finance as a source of funds for investment plans, compared to the larger corporate firms that may instead raise funds through equity and tapping into retained earnings.

Potential assistance / measures

The Ai Group recommends the following measures be further examined in order to improve access to finance by small businesses:

- Enhanced financial training for smaller businesses: Governments at both the Commonwealth and State levels have various training programs to foster business growth. One example is the Enterprise Connect program which provides business advisory services. Consultations with small businesses confirm this and other similar programs should be expanded to provide small businesses with training in cash flow management and broader accounting techniques. Provision of further and more widespread financial management mentoring is also essential.

- Enhanced provision of information regarding finance options: Consultations with small businesses confirm there is a lack of information and understanding by some small businesses regarding financing options and accessing government sponsored grants programs. There is a role for governments to work closely with Ai Group to facilitate greater information provision to small businesses.

- Competition in the market for SME lending: Consultations with small businesses suggest that over and above the lack of credit due to the recent tightening related to the GFC, there is potentially a lack of competition in the market for lending to small businesses. Greater competition can improve credit availability and reduce its cost.