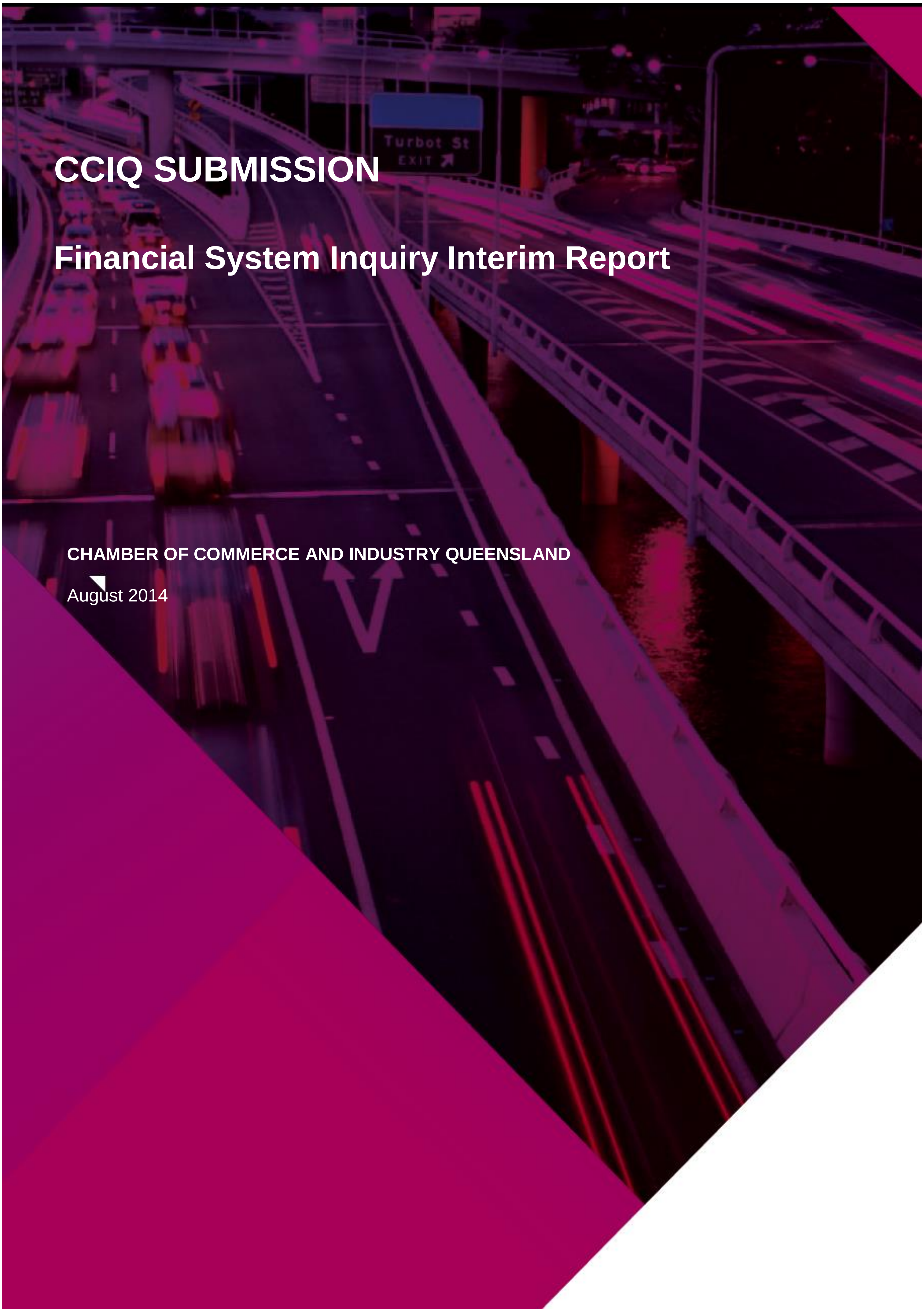
CCIQ SUBMISSION

Financial System Inquiry Interim Report



CHAMBER OF COMMERCE AND INDUSTRY QUEENSLAND

August 2014

Introduction

1. The Chamber of Commerce and Industry Queensland (CCIQ) is the state's peak industry body for small and medium businesses. CCIQ welcomes the opportunity to make a submission to the Financial System Inquiry Interim Report.

2. CCIQ's submission focuses on how Australia's financial system can best meet the financial needs of small and medium businesses. Feedback is provided on the Inquiry's observations and policy recommendations that relate specifically to the level of competition in small business lending, access to and affordability of credit, conditions of funding and leveraging of superannuation funds. CCIQ considers these aspects should be key priorities in the Inquiry's Final Report.

3. CCIQ believes that well targeted improvements in these areas will ensure Australia's financial system continues to underpin a diversified and stable business operating environment for small and medium businesses. Importantly, there is opportunity for the financial system to assume a greater role in facilitating small and medium business growth.

Competition and consolidation

Inquiry policy options or other alternatives:

- *No change to current arrangements*
- *Expand CCR by making it mandatory, adding new fields and/or extending it to SME lending*

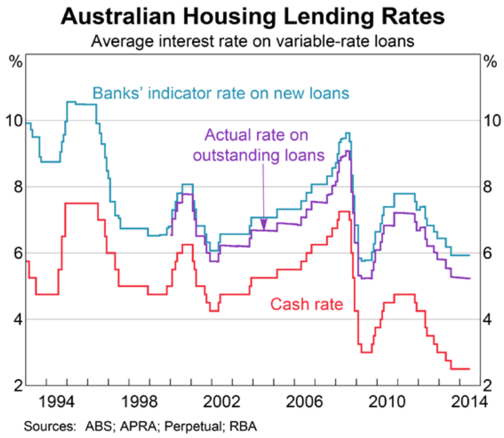
4. CCIQ believes comprehensive credit reporting (CCR) can be beneficial if it helps facilitate more affordable or more favourable conditions for small business loans. A positive reporting system that provides more frequent and comprehensive data about small business credit history would improve the way lenders assess risk. This would be especially beneficial for small business owners that use equity in their homes to fund their businesses. Regular mortgage repayments would therefore be considered favourably in a credit application. Small businesses would also benefit from being able to verify a client or customer's liability ahead of any business transactions.

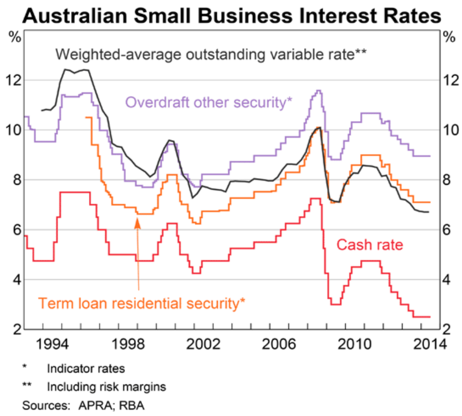
5. CCIQ therefore supports making CCR mandatory and extending it to SME lending. This would potentially improve access to finance, help speed up the process of finance approvals and facilitate more efficient SME banking. For these benefits to be realised however, there needs to be a genuine change to the traditional model of SME lending that combines better information with better relationship banking.

6. Feedback from Queensland small businesses points to a lack of highly skilled business banking managers that have a practical understanding of business operations, the relevant customer base, credit lifecycle and how access to finance can help grow the business sustainably. The banking relationship is especially crucial for start-up businesses that may not be able to offer a comprehensive credit history. The banking sector also needs to improve its dealings with small businesses in a way that clearly distinguishes between the owner's personal finance needs and the finance needs of the business.

The Inquiry seeks further information on the following area:
Is there evidence that spreads in SME and personal lending reflect reduced competition?

7. There has been a noticeable increase in the spread between the cash rate and the variable interest rate paid by small businesses following the global financial crisis. The spreads have increased even for small business loans that are residentially secured.





8. The re-pricing of risk associated with small business lending following the GFC does not fully account for the increase in SME lending spreads. Queensland small and medium businesses believe that the spreads in lending rates are a result of the market dominance of the major banks and the perceived risks that do not necessarily reflect the true cost of finance.

9. A higher proportion of credit is being allocated to the residential housing market in response to higher margins for lenders, which is lessening the competition in the SME market. While the appetite for credit has been subdued in recent times, CCIQ notes that Queensland businesses remain optimistic about strengthening consumer demand and will increasingly seek credit to capitalise on emerging market opportunities. It is therefore timely to explore initiatives that would potentially address the spreads in SME lending rates.

10. The majority of Queensland businesses rely on the four major banks (CBA, NAB, ANZ and Westpac) and do not have the capacity to source finance from wholesale markets. CCIQ supports retaining the four pillars policy of not allowing future mergers or acquisitions in the banking sector which would consolidate the dominance of any one of the four major banks. CCIQ also suggests initiatives to assist in the development of a fifth pillar to provide effective competition to the existing large banks and more specifically, the SME product markets.

11. Initiatives to help increase competition in the SME market include:
    - encouraging new market entrants, including foreign owned banks and non-bank lenders;

- ensuring second tier/regional banks are not unfairly disadvantaged by capital requirements;
- reducing the guarantee fee for second tier/regional banks still covered by the Guarantee Scheme for Large Deposits and Wholesale;
- lowering the capital requirements for commercial loans, which would remove the bias toward housing loans and provide greater incentives for small business lending; and
- investigating cost-effective mechanisms that would facilitate bank account switching.

12. CCIQ's engagement with Queensland small businesses highlights that the barriers to switching banks further constrain banking competition. Those businesses considering changing banks raise concern about fees and charges as well as the time and resources required to go through the process of change. For example, considerable time is incurred in cancelling regular payments and setting up new accounts for debtors and creditors. Queensland small businesses believe the costs involved in switching banks outweighs the benefits that may be realised from alternative banking products and services. Tailored switching services for SMEs would help address some of these concerns. In addition, the implementation of portable business account details, while an ambitious goal, offers a real long-term solution to reducing the barriers to switching banks.

Funding Australia's economic activity

Inquiry Observation
There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.

13. CCIQ strongly supports this observation.

14. Stricter lending requirements post-GFC has limited the avenue for small business to access finance for working capital, investment and business expansion. While the banking sector has a responsibility to effectively manage lending risks, CCIQ notes that existing regulations are restrictive and fail to accommodate viable businesses.

15. CCIQ's engagement with Queensland small businesses highlights the following difficulties when seeking new finance for capital investment:
    - Enhanced legal requirements for larger investments;
    - Ongoing and excessive requests for financial and other business information;
    - Increased delays in decisions;
    - Inflexibility of repayment plans; and
    - Reduced loan types available, particularly no interest only loans.

16. Depending on the structure of the business, and whether it is new or existing, this requires the provision of financial reports and statements, tax returns, leases, business activity statements and bank statements. Not only is this a time-consuming process, but it is an expensive one as it is difficult to go through the application process without the advice of a broker or agent. Employers have told CCIQ that they began the process, but changed their mind once they became fully aware of what was involved.

17. SMEs also point to greater restrictions in using existing lines of credit for their everyday working capital. This includes:
    - Higher serviceability or interest covering ratios;
    - Lower loan to value ratios;
    - Additional fees and charges;
    - Additional security and administration requirements;
    - Ongoing review, tightening and more stricter enforcement of terms, conditions and covenants;
    - Calling in the loan;
    - Higher interest rates compared to other lending institutions;
    - Reneged on previous agreements;
    - Stricter with certain facilities such as overdrafts;
    - Greater focus on cash flow rather than assets; and
    - Difficulties around refinancing of existing loans.

18. Feedback from Queensland small businesses highlights the need for credit assessments that go beyond the inherent risk profile at an industry level to better reflect the specific risks of each actual business. Not all small businesses operate with the same risk levels and each business needs to be assessed on its own merit rather than using standardised loan to value ratios. Other factors such as the ability of the business to manage cash flows during peaks and troughs and potential for growth in changing markets are important considerations that are currently not included in credit assessments.

Inquiry policy options or other alternatives:

- *No change to current arrangements.*
- *Facilitate development of a small- and medium-sized enterprise finance database to reduce information asymmetries between lenders and borrowers.*

19. Current arrangements provide inadequate access to finance for Queensland small and medium businesses to invest, grow and employ. Accordingly, CCIQ considers there is merit in developing an SME finance database to address information gaps.

20. CCIQ considers it reasonable that an SME finance database leverage the existing ATO small business benchmarks, which include information from tax returns and business activity statements, as well as data from the comprehensive credit reporting system (i.e. date of finance, nature of credit, loan limits, repayment history and date of account closure). This would contribute to a more meaningful assessment by lenders of SME behaviour.

21. However, appropriate policies would be needed to address privacy concerns. SMEs would be concerned if their competitive strategy were compromised through the sharing of commercial in confidence information. Careful consideration of how information in the database may be used not just by lenders but in business to business dealings is therefore critical. The additional costs involved in administration and keeping the database up-to-date must also be weighed against the usefulness of having a centralised source of detailed information. Furthermore, the issue of distribution of administration costs for the database and the extent to which this is passed on in the form of higher priced SME finance must be addressed. CCCIQ believes that expanding on the existing ATO arrangements for small business

benchmarking would be a useful starting point for developing a more comprehensive SME finance database.

22. CCIQ believes that a database, by itself, would be insufficient to deliver to desired change in improved access to finance for small and medium businesses. Complementary initiatives are required, including education and training programs to improve assessment skills amongst business lending managers and credit departments, with a particular focus on small business and start-up lending.

The Inquiry seeks further information on the following areas:

- *To what degree will technological developments resolve issues related to information asymmetries in SME lending?*
- *What are the best options to narrow the informational gaps between lenders and SME borrowers?*
- *Could the use of certain loan covenants be reduced, while still providing SMEs with adequate access to finance and lenders with appropriate protection?*
- *What are the prospects for a market for securitised SME loans developing?*
- *What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?*
- *What are the best options for improving the tax treatment of VCLPs?*

23. CCIQ believes the use of technology can add value to SME lending transactions and help reduce the costs of information sharing between lenders and businesses, and underpin sophisticated credit analysis. If combined with an effective banking relationship, CCIQ considers technology advances will go a long way toward addressing information gaps. Use of technology can also help SMEs with their financial management skills and reinforce their creditworthiness. However, CCIQ notes there is potential disadvantage to SMEs if the increased use of technology leads to increased risk pricing for business loans.

24. The best way to narrow the information gaps is by developing a code of practice for lending to creditworthy small businesses. While the current Code of Banking Practice extends to small businesses, CCIQ considers a separate code of practice for small business lending is needed to recognise the differences in how small businesses use credit and to progress meaningful change in lender behaviour. This code of practice needs to clearly explain the information requirements for small businesses to obtain credit, include timeframes for credit decisions, provide effective feedback on refusal of credit so businesses can take steps to rectify, and provide guidelines for notifications about changing loan terms and conditions. CCIQ also recommends standardised disclosures or business loan fact sheets to assist small businesses in comparing the terms and conditions of loans offered by various lenders.

25. CCIQ considers that a separate code of practice for small business may help reduce the complexity of non-price covenants, which have tightened since the GFC and become overly restrictive. Queensland small businesses raised concerns about covenants preventing innovative practices or growth opportunities. For example, a small business may potentially breach their loan covenant when making a new investment decision that alters their current cash flow but would yield future sales growth from a new market opportunity. A specific code of practice for small business lending could set out notification requirements that would ensure the business owner retains a line of credit in such situations while still

providing adequate protection for the lender through guidelines that outline proportionate responses to small business operational changes.

26. In terms of a securitised market for SME loans, CCIQ believes a credit guarantee system for small and medium businesses is worth exploring. The United Kingdom, Canada and the United States have introduced guarantees on small business loans. Given the importance of small and medium business growth to improving Australia's productivity and competitiveness, there is a valid role for government to play in underwriting to some extent these businesses access to finance.

27. CCIQ believes there are structural barriers that need to be addressed to increase broker activity in SME finance. CCIQ notes that vertical integration in the banking system has resulted in the big four banks increasing their share of the mortgage brokering industry, which has reinforced the bias toward housing credit. Also, small business lending tends to be more complex than mortgage brokering. It requires brokers to have knowledge of debtor finance, equipment/vehicle leasing, business investment accounts, business transaction accounts, corporate credit cards, trade finance and various other types of borrowing requirements. Furthermore, brokers would need to develop effective banking relationships to understand business needs if they are to successfully leverage the SME market.

28. While CCIQ considers a thriving venture capital market is an important source of finance for start-up businesses, any options for improving the tax arrangements of Venture Capital Limited Partnerships (VCLPs) should be considered as part of the Federal Government's Tax White Paper.

Superannuation

Inquiry Observation
If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.

29. CCIQ does not support this observation. Policy should seek to mitigate systemic risk while also maximising superannuation capital for productive uses, especially innovative SMEs. Direct leverage, if appropriately regulated, can help increase the availability of SME finance and facilitate diversification of superannuation funds assets. Accordingly, CCIQ believes the Inquiry's Final Report should explore options to balance the risks of this approach rather than prohibiting the direct leverage of superannuation. For example, improving the quality of advice to super fund members and better performance data on SME investments may provide greater incentive for super funds to provide SME financing. CCIQ also notes that general prohibition of direct leverage would have implications for SMEs that may be considering a gearing investment strategy for the business through their self-managed superannuation fund.