Affordable capital for SME growth

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Australian Government

Australian Small Business and Family Enterprise Ombudsman

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Foreword

Across our economy it is recognised that small to medium enterprises (SMEs) – businesses that employ less than 200 people – drive growth. Our SMEs represent over 99 per cent of all businesses, contribute 57 per cent of the GDP, and employ over 7 million Australians – 67 per cent of total employment. SMEs rely on finance to start, operate and grow their business. As emphasised in our 2017 *Barriers to Investment* report[1], sources of capital for growth are scarce and expensive.

In 2017, the Reserve Bank of Australia (RBA) stated 'It's not the absence of entrepreneurial spirit, it's the absence of entrepreneurial finance that's been the main factor holding that part [small business] of the economy back.'[2] The RBA further identified 'the reduction in the risk appetite of lenders following the global financial crisis appears to have had a more significant and persistent effect on the cost of finance for small business than large business'.[3] It is critical to address the change in risk appetite, as the primary use of funds by SMEs 'is for productive investment, such as commercial buildings, machinery, software and other forms of intellectual property.'

Currently, SMEs can access debt capital from banks in the form of loans, generally for up to three years if they own real estate – normally the family home – and are willing to use it as security. SMEs can also access short term, low value, and higher-cost capital from alternative lenders where the lender has access to the transaction history on business performance and has security over assets such as plant, equipment, stock and debtors.

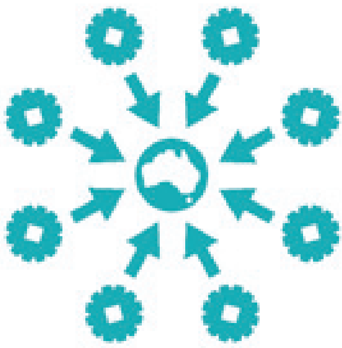
An alternative is to access capital in the form of equity by issuing shares to investors. SMEs can seek capital through crowdsource funding or private shareholder investment. This requires an SME to issue unlisted shares, which gives investors an interest in the business. For many SME business owners it is difficult to cede partial or full control to external parties.

This market failure, resulting in a limited supply of patient capital for growth, has been experienced worldwide. We have undertaken this inquiry to explore how jurisdictions similar to Australia addressed this market failure to provide affordable capital to SMEs. The recommendations in this report outline initiatives to increase the supply of capital and inform and prepare SMEs to seek capital.

Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman

1. Australian Small Business and Family Enterprise Ombudsman, *Barriers to Investment,* November 2017
2. Debelle, Guy., *Business Investment in Australia,* UBS Australasia conference 2017
3. Kent, Christopher., *The Availability of Business Finance*, 13 December 2017

Small and medium-sized enterprises – snapshot



Contribute
$614.96
billion
of GDP or 57%

Time poor – majority work average overtime
7 hours

56%
Operated by GenX or Millenials

Actively growing
1 in 10
Nearly half aim to expand

50%
Have been in business less than 10 years

They employ
7 million
or 67% of all employment

Recommendation summary

Supply

Recommendation 1: Business Growth Fund

The private sector to establish an investment fund focussed on long-term funding solutions for SMEs. The fund will offer both debt (loans) and equity (investment) to support SME growth. SMEs can apply for amounts between $250,000 and $5 million, with terms up to seven years, secured against the business.

Recommendation 2: Government Guarantee Scheme

Australian Government to establish a Government Guarantee Scheme. Member banks can draw on the guarantee as a form of security. The guarantee will facilitate increased lending to SMEs with a viable business model, but without real estate to meet bank security levels.

Recommendation 3: APRA prudential measures

Australian Prudential Regulation Authority (APRA) to move from the one-size-fits all model and allow regulated institutions to apply risk weightings to specific risk factors.

Recommendation 4: Capital Enhancement Fund

Australian Government to establish a capital fund to provide tier two capital instruments to banks. This will address the funding differential that is known to exist between tier one banks and other banks.

Recommendation 5: Personal Property Security Register

Australian Financial Security Authority (AFSA) to overhaul the register – at a minimum the public interface – to make it fit for purpose so a non-legally trained individual can accurately register title, to best utilise assets as security against lending.

Demand

Recommendation 6: Finance-ready SMEs

SMEs to work with their trusted advisers to get their business finance-ready.

Recommendation 7: Open banking reforms

Australian Government to implement and promote government initiatives of comprehensive credit reporting and the consumer data right in banking – part of Open Banking – in line with the Government’s schedule and the benefits widely promoted to SMEs.

Recommendation 8: SME guide to financial products

Australian Small Business and Family Enterprise Ombudsman (ASBFEO) to develop a short guide on financial providers, the range of financial products available and what stage of a business cycle each product is designed to fit. The guide will be distributed through the networks of SME advocates and publicised through social media.

Lending landscape

Debt or equity finance?

External funding for a business can be in two forms, debt or equity.

Debt – where a lender provides capital for a fixed term and it must be repaid in full.

Lenders seek a return through regular repayments including interest and fees during the term of the loan. At the end of the term, the business must pay back the remainder of the loan. Debt is provided by banks and alternative lenders, who have no interest in owning the business.

Debt is attractive to small businesses where the terms of the loan can be adapted to the needs of the business. There is no dilution of control and the debt obligation can be retired by repayment of any outstanding amount.

Equity – where investors provide capital in exchange for shares in the company.

Investors directly bear the risk of the business failing, and conversely can make significant gains if the company prospers and the value of shares increase. Investors seek a return from growth in the value of the shares and through payment of dividends. There is no short-term requirement for the business to pay back the capital.

Equity investors tend to have an investment time limit, and look to sell their shares for a profit within that time. Equity investors take a targeted approach to the market, seeking established businesses that can be taken on a high-growth path. There are large parts of the SME marketplace where equity investors simply do not invest.

Equity is less attractive to an SME for long-term growth and requires divesting partial or full control of the business. A common response from SMEs is a reluctance to introduce new shareholders, which increases reporting obligations and reduces control.

Who are the financial providers?

Providers of debt must hold an Australian Financial Services Licence (AFSL). Banks and other financial institutions that are subject to the prudential regulations of APRA, are permitted to take deposits and lend funds to consumers and business customers. They are classed as Authorised Deposit-taking Institutions (ADIs).

SMEs can also source debt funding from other financial service providers, who are not banks but hold an AFSL. The AFSL is issued by the Australian Securities and Investment Commission (ASIC) and holders are subject to regulation by ASIC through the *Corporations Act 2001*. The majority of these alternate lenders are not ADIs and are limited in the types of products that can offer.

Equity can be sourced through crowdfunding platforms, business angels, venture capital funds and private equity investors. Legislation sets minimum requirements for a company seeking investors. The legislation is aimed at ensuring potential investors have full information on which to base their decision.

What security is required?

In lending, banks look for real estate as security and a guarantee from the business owners. Some banks now offer unsecured business loans on the basis of taking a charge over the business assets and a personal guarantee from the directors. They commonly limit their exposure by capping the loan facility at $100,000.

As business assets can deplete over time, banks also look for additional security through mortgages over real estate owned by the business, or the business owner, and will calculate the amount they will loan as a proportion of the value of the real estate. If the business owner does not own sufficient real estate, the loan is often declined.

The bigger the loan requested, the more likely this issue will become a problem for the SME business owner. Home ownership in the key entrepreneurial period of life (ages 25-34), is down by over 30 per cent over the past 25 years.[4] It is expected that Australia's house prices will remain flat over the 2018–19 financial year. Some forecasters expect housing markets to decline.[5]

Alternative lenders have entered the market, such as fintechs, who generally operate on a software platform and offer short term loans up to $250,000, though the average is less than $100,000. Loan applications are assessed on the owner's credit history and recent business performance, secured against the business assets. Those loans will be short term, in most cases for less than 18 months, and carry significantly higher interest rates.

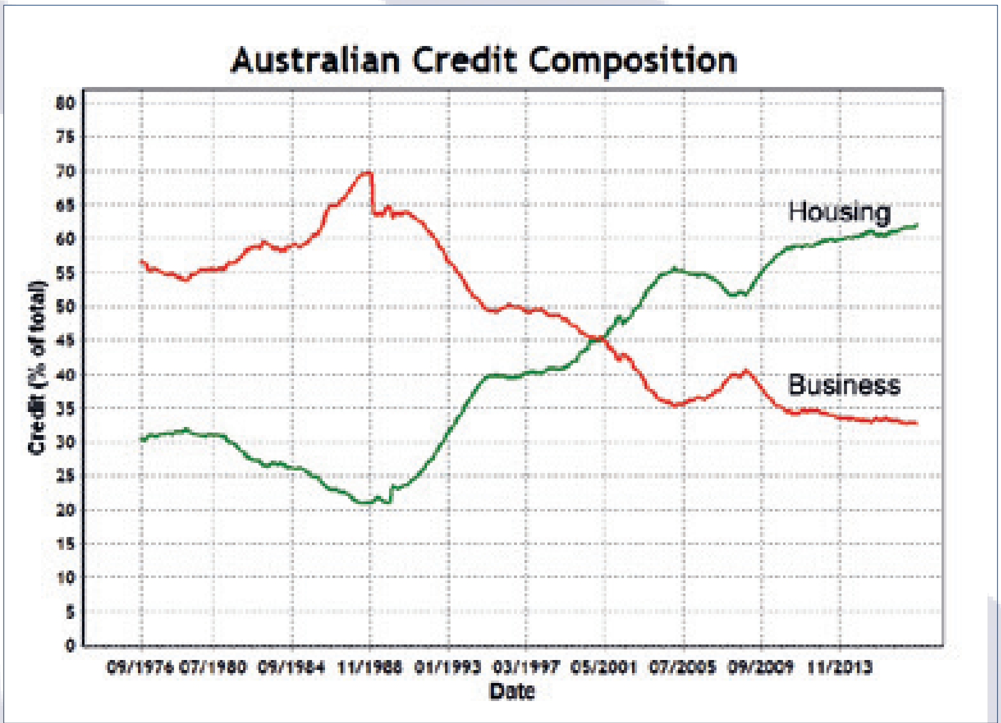
Equity investors do not require security as they take an interest in the business through buying shares.

4. Productivity Commission Draft Report, *Competition in the Australian Financial System*, p 249, January 2018
5. Allison Worrall, Domain, *Australia's house prices to remain flat over 2018-19*, June 25 2018

Market failure

Limited competition – and risk-weighted appetite focussed on real estate – limits lending to SMEs. The market failure arises where SMEs have limited collateral, other than a family home, to provide security for a loan. While private equity is an alternative source of capital, the majority of investors seek a rapid return. Private equity investors attempt to implement managerial and operational changes to improve the company's performance, before selling it for a profit.

The Productivity Commission noted in the *Draft Inquiry Report into Competition in the Australian Financial System* (2018), 'APRA capital requirements … create an incentive for lenders to seek a residence as collateral (where available) and for SME borrowers to offer a residence as collateral to access the lowest price finance'. A recognised consequence of the global financial crisis in 2008 has been a concentration of lending exposures to residential mortgages as they carry less risk. This has carried through to lending to SMEs, as banks have shifted their emphasis and require enhanced levels of real estate security for SME loan facilities.



Source: Investment Analytics – APRA data

The levels of capital held by a bank inversely impacts overall profitability. Meeting the minimum capital requirements is a dynamic issue for banks. Risk is part of doing business and banks have the ability to price in the risk of uncertain future prosperity and capacity to repay the loans. While assessing those risks and structuring security arrangements is complex and costly for banks, they recoup these costs by charging interest rates higher than residential mortgage rates.

The RBA has noted there are fewer competitors in the small business loan market, where the four major banks currently hold an 83 per cent share.[6] The share of financial lending outside the prudentially regulated sector is very small.

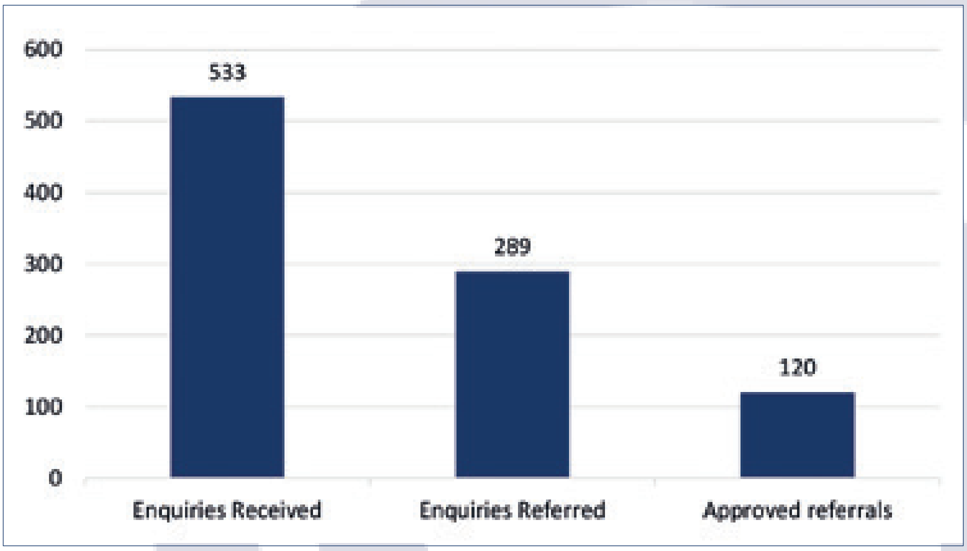
6. RBA Submission, *Competition in the Financial System Submission to the Productivity Commission Inquiry*, September 2017.

Alternate lenders do not require bricks and mortar security but do charge significantly higher interest rates, offer low amounts over short terms, and may seek a personal guarantee. Yet, during a period of expansion, the cash flow of an SME is tight. Servicing a high cost, short term loan is in many cases counterproductive and simply not possible. Alternate lenders can charge interest rates from 16 to 60 per cent. These finance solutions might provide a useful, short-term stop-gap but cannot provide patient capital for growth over time.

This market failure is often misunderstood based on the measures provided by Australian Bureau of Statistics (ABS). The ABS figures show that only 15 per cent of all businesses apply for debt or equity finance, of which 90 per cent are approved. This does not capture the SMEs that do not get as far as making an application.

Statistics from broker MoneyQuest Finance Specialists, represent the more common experience of SMEs seeking finance. MoneyQuest surveyed their brokers and found that 46 per cent of enquiries do not go further than the initial conversation. Of the 54 per cent referred, 41 per cent are approved. That is, less than 22.5 per cent of enquiries received result in an approved referral.

SURVEY RESULTS OF SME FINANCE ENQUIRIES



Source: MoneyQuest Finance Specialist, *SME Survey*, 1 July 2017 – 20 June 2018

The rate of rejection before application reflects banks move to automated processes using check lists to assess the initial enquiry. As SMEs typically have less documentation and shorter financial histories than large corporations, they often fail at this first hurdle. A study undertaken in New South Wales indicates that SMEs are four times more likely to be rejected for lending than large businesses, and 30 per cent more likely to be rejected for equity finance.[7] The report shows that high-growth employing firms represent approximately 10.5 per cent of the SME population. A successful loan application by these SMEs will always require tailored assessment.

7. Jobs for NSW, *Market Opportunity Analysis Financing for SMEs in NSW*, 20 September 2017

Supply recommendations

To begin to address market failure there needs to be an increase in the supply of capital in Australia for SME lending and increased competition between financial providers. Further analysis will need to be undertaken to determine where to source such additional capital – government or private sector – and how best to employ that capital to significantly increase lending to SMEs.

State governments are increasingly taking the initiative to support their SMEs with access to capital and the result will be a patchwork of offerings. Without a national solution, the capacity to access affordable capital will be at least partially dependent on where a business is located. The following recommendations seek to establish a national solution to increase the supply of affordable capital for SMEs to grow.

Recommendation 1: Business Growth Fund

The private sector to establish an investment fund focussed on long-term funding solutions for SMEs. The fund will offer both debt (loans) and equity (investment) to support SME growth. SMEs can apply for amounts between $250,000 and $5 million, with terms up to seven years, secured against the business.

The fund will operate commercially, independent of Government. The fund will offer both loans (debt) and investment capital (equity). Debt will be available in the form of a traditional loan, with repayments over terms of up to seven years, and secured over business assets and owner/director guarantees. Parameters for lending will be determined in consultation with investors and Government regulators, such as APRA. Equity will be available in the form of purchasing shares in a business taking a non-controlling interest. SMEs that receive funding will also be provided with mentoring, coaching and access to a talent pool of expert staff, to maximise the benefits of the patient capital investment.

An initial pool of $1.5 billion in capital could be sourced from the Future Fund, superannuation funds and banks. Loan and investment decisions will be made by professional managers independent of Government. Performance will be assessed on a fully commercial basis according to private sector funding models, against average annual rates of return.

An independent investment committee will be responsible for setting the overall parameters for lending and investments. Government's role will be limited to initial promotion of the partnership construct and to assist clearance of possible regulatory barriers.

It is expected that the delivery of the fund will use technology to create a low-cost delivery model. An automated triage platform will require SMEs to lodge key documents for assessment – such as a business plan and cash flow projections. The credibility of the application will be undertaken face-to-face.

Who will benefit?

1. Individual SMEs with growth potential will have access to a new source of funding either through debt or equity funding.
2. Institutional fund managers through the development of a new investment class, with commercial rates of return set according to the business opportunity and the term of the finance provided.

An example of a similar initiative is the British Growth Fund (BGF). The fund was initiated in 2011 to provide SMEs with long-term financial investment. It takes a minority equity stake (10–40 per cent) in SMEs that can demonstrate a growth trajectory.[8] With a balance sheet of £2.5 billion, £1.4 billion has now been invested across 220 SMEs, with the delivery model intentionally establishing a regional focus and physical presence, which has taken time and resources and led to sustained growth in investments. Notably, 73 per cent is invested outside of London and the South East of England.[9]

> 'In a year [2016/17] when all markets rose, our average capital return across the whole portfolio was 35 percent compared to 12.5 percent for the FTSE All Share, 14 percent AIM All Share and 9.2 percent FTSE Small Cap Ex Investment Companies.'[10]

The value of the fund can be seen through the following example:

- TD4 Brands, the parent company of UK Boost Juice Bars and The Shake Lab, has increased sales by 160 per cent in three years following initial investment by the fund in 2013, enabling the company to expand the number of Boost Juice Bars from 10 to 32.[11]

A similar fund has also been established in Canada in 2017. The Canadian Business Growth Fund comprises Canada's leading banks and insurance companies to provide long-term capital to help businesses grow.[12] Typical investment in each company is expected to range between C$3 and C$20 million.[13]

8. BGF Invested in Growth, *Our Offer*, 2018
9. BGF Invested in Growth, *Invested in Growth,* 25 June 2018
10. BGF Invested in Growth, *Review 2016/2017*, p.20, 2017
11. BGF Invested in Growth, *TD4 secures more BGF investment as sales 'more than double',* 10 February 2016
12. Canadian Business Growth Fund, *Who We Are* and *Learn About*, 2018
13. Canadian Department of Finance, *Ministers Morneau and Chagger welcome launch of the Canadian Business Growth Fund*, 9 March 2017

Recommendation 2: Government Guarantee Scheme

Australian Government to establish a Government Guarantee Scheme. Member banks can draw on the guarantee as a form of security. The guarantee will facilitate increased lending to SMEs with a viable business model, but without real estate to meet bank security levels.

An Australian Government Guarantee Scheme (GGS) could be established. The scheme would partially guarantee SMEs who do not qualify for bank funding, under these circumstances:

- insufficient real estate assets to pledge as security
- the loan tenor [duration] needing to go beyond the two to three-year period banks are willing to consider
- the SME operates in a sector where the commercial banks have debt appetite restrictions.

A guarantee will be accessible to members of the scheme with eligibility limited to ADIs (banks). This will ensure the guarantee is issued within existing prudential regulations for lending.

Member banks will have the ability, where a loan application from an SME is assessed favourably but lacks sufficient security or is in a challenged sector, to apply to the GGS for a guarantee to form part of the security. The role of Government would be limited to input and influence of the regulatory framework, and provision of guarantees within the schemes framework.

The GGS will be managed by an independent agency, responding to guarantee requests from member banks in the normal course of their business activities. Member banks will pay an annual subscription fee and an additional fee for each guarantee issued.

Who will benefit?

1. SMEs will have a new form of security to support loan applications where there is no, or a shortfall in, real estate security.
2. The GGS has the potential to increase competition, as loans supported by the scheme reduce the risk-weighted capital required to lend to SMEs, increasing the number of loans that can be written.

An example of the impact of providing a government guarantee is the United States (US) Small Business Administration (SBA) program. Since the 1950s, the SBA has administered programs to support small business; including loan guarantees to encourage lenders to provide loans that small business might not otherwise obtain on reasonable terms and conditions.[14] The agency does not lend money directly to small business owners. Instead, it sets guidelines for loans made by its partnering lenders, community development organisations, and micro-lending institutions.

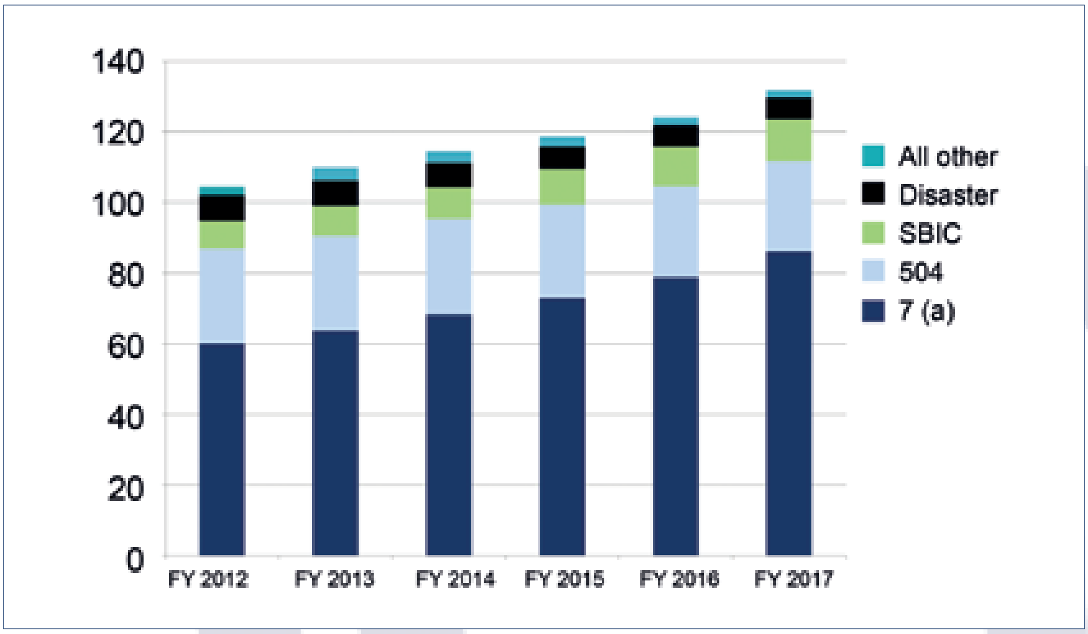
14. Small businesses are defined as firms employing fewer than 500 employees. US Small Business Administration Office of Advocacy, *Small Business Profile – United States*

The SBA reduces risk for lenders and makes it easier for them to access capital.[15] SBA guarantees against default portions of business loans, which can range from US$5.5 to $500 million. Two key programs where the SBA stands as guarantor are:

- The SBA 7(a) loan – offers working capital to fund start-up costs, buy equipment and purchase/ expand an existing business. The average size of the loan is approximately US$250,000 over nine and a half years.[16]
- The SBA 504 loan – provides finance to purchase fixed assets, e.g. real estate, building and machinery. The average size of this loan is US$560,000 over 19.5 years.

The SBA is the taxpayers' custodian of a $132 billion loan portfolio of small business guaranteed loans and direct loans. During the 2017 financial year, the loan portfolio grew by 6.1 per cent. The Agency's 7(a) loans expanded by $7.4 billion, which constitutes 65 per cent of the portfolio (see Figure 1).

SBA'S OUTSTANDING LOAN PORTFOLIO (USD BILLIONS)



Source: US Small Business Administration, FY 2017 Summary of Performance and Financial Information

The value of the guarantee can be seen though the following example:

- SeaDek, a company producing innovative alternatives to marine traction products, was named 2018 Small Business Exporter of the Year. The company used around US$4 million in SBA supported financing to fund the expansion of their manufacturing facility, to grow their business internationally from three per cent to nearly 10 per cent of total sales in 29 countries.[17]

15. US Small Business Association, *Loans*, 2018
16. US Small Business Association, *SBA 7(a) & 504 Loan Data Reports*
17. US Small Business Association, *Florida Small Business Wins SBA's 2018 Exporter of the Year Award*

Recommendation 3: APRA prudential measures

APRA to move from the one-size-fits all model and allow regulated institutions to apply risk weightings to specific risk factors.

APRA regulations are based on the international framework for banks, developed by the Basel Committee on Banking Supervision. APRA regulations require banks to carry capital to absorb potential losses from lending activities.

The banks claim that they cannot afford to increase unsecured lending to SMEs due to the cost of capital that must be held to meet APRA's prudential regulations. The Productivity Commission considers that 'APRA's interpretation of Basel guidelines on risk weightings that non-IRB banks use for determining the amount of regulatory capital to hold, puts it among the most conservative countries internationally'.[18]

Critically, for lending to SMEs not secured by a residence, APRA requires a single risk weighting of 100 per cent. The Productivity Commission has called on APRA to consider allowing banks to nuance this weighting. Banks should be able to align this risk weighting to the size of a loan, the type of loan – line of credit, overdraft – and the risk profile of the individual business. This would bring the regulations in line with the Basel proposed risk weights. Basel allows stepped weights from 75 per cent for up to €1 million for SME retail lending, through to 150 per cent for lending for land acquisition, development and constructions.

Who will benefit?

1. Banks will have reduced cost of capital held against loans to SMEs.
2. SMEs will have more capital available for sound lending applications.

18. Productivity Commission, *Competition in the Australian Financial System – Draft Report*, 2018

Recommendation 4: Capital Enhancement Fund

Australian Government to establish a capital fund to provide tier two capital instruments to banks. This will address the funding differential that is known to exist between tier one banks and other banks.

Another approach to address the cost of capital could be the establishment of a Capital Enhancement Fund (CEF). The Fund will address the well-understood cost of funding differential that exists for the tier two banks. That differential currently provides an advantage to the tier one banks estimated by the RBA to have averaged around 20 to 40 basis points from 2000–13 (worth around $1.9 billion annually to the major banks).[19] The Fund will enable a 'capital build' for non-tier one banks by providing access to a new pool of capital.

The CEF will be Government supported and provide a source of tier two hybrid instruments. Hybrid capital instruments carry an interest or return rate, which can be set for the duration of the funding agreement. The facilities will be repayable by the financial institution as determined over the duration of the agreement.

The CEF will purchase hybrid notes from the non-tier one banks for a set rate of return. Recognising that smaller ADIs may not use any capital advantage for the benefit of SME customers, the rate of return applying to the hybrid instrument will be structured to benefit banks that can show that the capital has been applied to additional SME lending. That benefit will manifest in a discounted dividend rate payable to the Government. Conversely, a bank that cannot show an increase in SME lending will be obliged to pay a higher rate of return.

Who will benefit?

1. Tier two banks will have access to additional capital at beneficial rates.
2. SMEs will benefit from greater competition as second tier banks will have access to more capital specifically for loans to SMEs.

A similar initiative in the US is the Small Business Lending Fund (SBLF). The SBLF is a US$30 billion fund that encourages lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than US$10 billion. The SBLF aims to stimulate small business lending by providing capital to participating community banks. The price a bank pays for SBLF funding will be reduced as the bank's small business lending increases. As of 1 March 2018, 274 institutions with aggregate investments of US$3.73 billion have fully redeemed their SBLF Treasury investment and exited the program, and five institutions have partially redeemed US$28 million (or 66 percent of their SBLF securities) while continuing to participate in the program. Since its inception in 2011, the majority of participants have increased lending to SMEs by at least five per cent. In the fourth quarter of 2017, 49 of the 56 remaining participants increased lending to SMEs by 10 per cent or greater.[20]

19. Productivity Commission, *Competition in the Australian Financial System – Draft Report*, 2018
20. US Treasury, *Report on SBLF Participants' Small Business Lending Growth,* 2017

Recommendation 5: Personal Property Security Register

Australian Financial Security Authority (AFSA) to overhaul the register – at a minimum the public interface – to make it **fit for purpose** so a non-legally trained individual can accurately register title, to best utilise assets as security against lending.

The Personal Property Security Register (PPSR) allows parties to secure an interest over particular assets, for a fee. There have been over 10 million registrations made on the PPSR. Industry experts indicate, that of the registrations they examine, up to 80 per cent are incorrect.[21] The accuracy of a registration is often not tested until challenged as part of insolvency activities, such as liquidation of a company.

Errors are due to the complexity of the registration process, which is in highly legalistic language. There is no validation processes during registration leading to many sophisticated businesses, such as financial providers, relying on specialist PPSR practitioners to implement software that overlays the PPSR and automates registrations.

Such specialist services are out of reach for a large number of SMEs, who cannot afford the set up costs ($3–6,000) to implement and populate front-end software, and engage a solicitor to bring invoice terms and conditions in line with transfer of title law. This is over 700 times more than the cost to register directly on PPSR website at $6.80.[22]

Yet using the PPSR can allow SMEs to offer business assets to financial providers as security. Overhauling the PPSR is vital as it will improve the access to, and quantum of, finance available for SMEs.

The overhaul must:

- remove the layers of complex and legal terminology
- explain each step in the registration process in plain language
- use smart forms that drive correct data entry. For example, only allow nine digits to be entered for an ACN and 11 digits for an ABN
- validate the registration to ensure its compliance with requirements.

If the PPSR is successfully overhauled, the Government must then undertake an education and awareness campaign. Existing users must be encouraged to check their registrations for accuracy and to delete out of date or obsolete registrations. Potential users need to be made aware of the PPSR, how it can be used to leverage assets, and how to make and maintain a registration.

Who will benefit?

1. Providers of finance will have greater accuracy for security interest.
2. SMEs will be aware of a tool that provides security to financial providers, thereby increasing their options to access growth capital.
3. SMEs will have the ability to secure assets under insolvency administrations.

21. Consultation with specialist PPSR practitioners such as EDX Australia Pty Ltd.
22. Australian Financial Security Authority, *Fees for using the PPSR*, 2015

Demand recommendations

In addition to the supply side recommendations, there are other factors we believe should be addressed at the SME business level. The following recommendations focus on educating SMEs on what they need to know and do before they seek capital.

Recommendation 6: Finance-ready SMEs

SMEs to work with their trusted advisers to get their business finance-ready.

A key factor in successfully obtaining capital is the quality of a credit funding application, which is dependent on the SME demonstrating their credit worthiness – having current business plans, cash flow forecast, demonstrable profitability and a track record of paying bills on time. SMEs should keep their trusted advisers (accountant, book-keeper, lawyer or business advisor) up to date with business plans, so any advice given is relevant to financing needs and future growth.

An analogy used by Marc Johnstone of SME CrowdFunder is buying a second hand car, where both cars appear in the same condition. Owner of car A **says** it runs well, whereas owner of car B can **demonstrate** it runs well, as they have log books and a service history. Which car would you buy?

Similarly, SMEs need to maintain detailed records of their business and keep their business plan current in preparation for seeking capital. When applying for capital, SMEs need to think like the banker. Consider what a banker would need to see to believe the business is a good investment. Banks place the greatest emphasis on past performance and will discount forecast revenue from proposed growth.

SMEs need to work with their book-keepers, accountants and trusted advisers to prepare the business for lending. For example, SMEs need to be aware that stretching payment to creditors, such as the Australian Taxation Office, may be seen by a financial provider that the business is not able to meet its debts on time. Similarly, claiming all development costs up front can reduce the apparent profitability of the business.

Where possible, SMEs should seek capital before it is needed. For example, if the intention is to expand into a new location in the next 12 months, finance should be sought while the business is profitable, rather than a week before a contract with a developer is due to be signed.

Of concern, our experience indicates that up to 45 per cent of SMEs are yet to take the advantage of accountancy software. Transitioning toward digital accounting and point-of-sale systems would help SMEs to maintain up-to-date and accurate financial records. More importantly, being automated and linked to the finance provider saves time, and allows a capital-seeking SME to easily produce a record of performance, business plans and cash flow projections.

Who will benefit?

1. SMEs seeking capital will have trusted records that can be easily provided to financial providers to support their business case for investment.
2. SMEs will benefit by adopting automated accounting processes, which will save time and costs.

Recommendation 7: Open banking reforms

Australian Government to implement and promote government initiatives of comprehensive credit reporting and the consumer data right in banking – part of Open Banking – in line with the Government's schedule and the benefits widely promoted to SMEs.

Government has commenced reforms to address the information asymmetry between borrowers and lenders. Comprehensive Credit Reporting (CCR) allows additional information about an individual to be provided to, and held by, Credit Reporting Bodies (CRBs). The Consumer Data Right in banking (CDR) will enable an individual and a small business owner to instruct their current lender to provide their financial data to another party.

The CCR comes into effect on 1 July 2018 and will impact owners of small businesses, as their personal credit history is taken into account when applying for a business loan. The CCR allows new categories of information to be provided and includes personal repayment history.

Repayment history can include:

- Credit cards, home loans and personal loans
- Making full or minimum repayments
- Reliability of meeting due dates.

The intent of the CDR is to allow the owner of the data to instruct the holder of the data, their financial institution, that their information can 'be transferred to accredited, trusted third parties of their choice.'[23] The title Consumer Data Right is misleading in this context as it captures individuals, consumers, and businesses. This will empower SMEs to provide their financial data to financial providers and other innovators of financial solutions.

CONSUMER DATA RIGHT

Source: The Treasury, *Consumer Data Right,* 9 May 2008

23. The Treasury, *Consumer Data Right, pg 1,* 2018

The Treasury proposes the following implementation timeline:

- 1 July 2019 – four major banks will make data available on credit and debit card, deposit and transaction accounts
- 1 February 2020 – four major banks will make data available on mortgages
- 1 July 2020 – consumer data on all products recommended by the Review will be available
- 1 July 2021 – all remaining banks will be required to comply, having had an extra 12 months in addition to the deadlines applying to the four major banks.

Financial providers have shown resistance to any change that will enable consumers, including SMEs, to easily seek capital from other providers. The CCR regime was first introduced in March 2014 through changes to the *Privacy Act 1988*. The reporting was optional, but due to limited activity by financial providers, the Australian Government announced in late 2017 that it was mandating CCR.

Government must enforce its schedule so the intended benefit to open data, i.e. to increase competition, can be realised. A realistic budget to promote, inform and educate both consumers and owners of SMEs must complement these initiatives.

Who will benefit?

1. Financial providers will have access to comprehensive data on applications for capital.
2. SMEs will have the right to provide comprehensive data to third parties of their choice.

Recommendation 8: SME guide to financial products

ASBFEO to develop a short guide on financial providers, the range of financial products available and what stage of a business cycle each product is designed to fit. The guide will be distributed through the networks of SME advocates and publicised through social media.

Banks tell us that only one in a hundred business owners over 30 years of age would consider changing banks. This manifests as a presumption by SMEs that when their bank declines a loan, they will likely have the same experience elsewhere.

SMEs will benefit from a clear understanding of the different forms of capital and their intended application. SMEs and their advisers need to determine not only how much capital they require but the type of product that best fits their needs.

The type of capital and its corresponding terms (e.g. equity stake in business and interest rate) depends on the business lifecycle, and the challenges and opportunities the business faces. This includes identifying:

- the reason for capital, e.g. launching a new product/service/brand, expanding into new markets/facilities, increasing production to meet a new contract, or improving cash flow (working capital)
- how much capital is required
- how long the capital will be needed for
- non-financial needs, e.g. industry experience and business networks.

A current poor level of awareness is demonstrated through figures cited at a recent roundtable held by the RBA. It was reported that the total market for debtor finance is approximately 4,500 SMEs but nearly 65,000 SMEs could be utilising these products.

Importantly, SMEs need to consider both debt and equity and consider traditional and alternative lenders. If an SME requires short term funding to make the most of a trade opportunity, it may be worth paying higher interest, say 25 per cent, for an immediate capital injection, if the opportunity will provide an even higher return over the longer term.

Similarly, not all equity investors seek a short-term gain. Some will seek high-growth opportunities with the intent to exit their investment within three to 24 months. Others, such as crowdsource funding, seek to invest capital for the long term and receive dividends year on year.

The guide will also inform time poor SMEs of the services offered by commercial brokers. When seeking a broker, an SME should consider the brokers' investment strategy, their qualifications and experience in the SME industry sector, and their track record in servicing the sector. Ultimately, the key is to understand the cost of the money, if it suits the SMEs purpose and is comparable to industry norms.

Who will benefit?

1. Financial providers will get more customers because more SMEs will know they exist and what they provide.
2. SMEs will better understand which financial products may suit their capital needs.

Appendixes

Appendix A: Terms of reference

Purpose

To explore the range of international initiatives that seek to provide affordable capital for small to medium enterprises (SMEs) to start and grow.

As reported in our Barriers to Investment report, Australia's 2.2 million SMEs rely on credit to start, operate and grow their business. Yet, banks consider SME's as high risk and offer lending with restrictive terms and conditions at a price few can afford. Our findings are in line with the Reserve Bank of Australia and the Financial System Inquiry 2014[1] which identified a funding gap, particularly for new small businesses.

The draft report from the Productivity Commission's inquiry into Competition in the Australian Financial System has found that SMEs do not have access to finance when they need it. If they can access finance it is on terms that limit the commercial viability of their investment plans. Banks prefer to lend when secured by bricks and mortar. This is evidenced by lending to owners of, and investors in, housing growing to double the lending to business.

The need for security coupled with a decline in the levels of home ownership, particularly in younger age groups, will result in the funding gap widening.

Our inquiry will investigate initiatives to provide affordable capital to SMEs to start and grow their business. The inquiry will examine:

- Australian initiatives where the government shares the lending risk including Clean Energy Finance Corporation, Export Finance and Insurance Corporation
- State and territory initiatives to support small business start-ups and growth
- International initiatives including the British Business Bank and the US Department of the Treasury's Small Business Lending Fund.

We will consult with Australian and international experts in SME lending and risk management and liaise with Australian regulatory bodies.

Outcome

From the reviews and consultations we will propose the implementation of initiatives we consider fit for purpose within the Australian regulatory framework for affordable lending to SMEs.

Timeframe

Commence: 4 April 2018
Final report: 30 June 2018

1. ASBFEO, *Affordable Capital for SME Growth Inquiry, Terms of Reference,* 2018

Appendix B: Initiatives reviewed

Jurisdiction	Initiative	Capital type	Fees/Terms	Restrictions	Length
Debt and Equity					
Australia	Regional Growth Loans NSW	Debt	Interest free. $3k + GST + legal costs	Loans between $200–$500k	4 years
Australia	Strategic Growth Loans NSW	Debt	Interest rate 9.2%. $3k + GST + legal costs	Loans between $500k–$1.2m	4 years
Australia	Loan Guarantees NSW	Debt	To be negotiated dependent on financial stability	Up to 50% of amount guaranteed (up to $5m)	2–5 years
Australia	GO NSW Equity Fund	Equity	Percentage of ownership of company	No data	No data
Australia	New Market Expansion Program TAS	Cash Flow	Must operate in Tasmania	No data	No data
Australia	Accelerating Growth Loans NSW	Debt	Interest rate 9.2%. $3k + GST + legal costs	Loans between $200–$500k	3 years
Belgium	Direct loans and Government Guarantees	Debt	Interest rate 2.1%	Maximum €250,000	2 years
Canada	Canadian Agricultural Loans Act Program	Debt	Interest rate Prime + 1%. Loan registration fee 0.85%	Loans to farmers up to C$500k. Co-ops up to C$3m	15 years
Canada	Business Development Bank of Canada (BDC) Business Loans	Debt	Interest rate $.7–9.7%	Maximum C$100k	5 years
Canada	Futurpreneur Canada	Debt	Application fee C$50	Maximum loan amount C$45k	2 years
Canada	Angel investment for innovative Quebec companies	Equity	Expected return of 5–10 times Angels' investment	C$250k–$1m	2–4 years
Canada	Canada Small Business Financing Program	Debt	Variable interest rate 3%. Registration fee 2% of loan amount	Maximum C$1m	10 years
EU Wide	Competitiveness of Enterprises and Small and Medium-sized Enterprises	Debt and Equity	Less than 10 employees	Maximum decided by lender	No data
Finland	Finnvera	Equity	Handling fee, interest rate fixed or tied to a reference rate	Minimum €10k (A$16,000)	3–15 years
Germany	Startgeld	Debt	Must have been in business for less than three years	Maximum €100k	No data
India	Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)	Debt	Interest rate 14–18%. Annual guarantee fee 2%. Annual service fee 0.75% on loans INR500k–20m	Maximum INR20m (approx. A$400k)	No data

Jurisdiction	Initiative	Capital type	Fees/Terms	Restrictions	Length
Israel	Small and Medium Business Fund	Debt	Gov. application fee 1–2% depending on size of business. Risk premium 0.5–1.5% depending on size of business	Maximum depends on size of the firm – up to NIS$100m	5 years
South Korea	Crowd Funding	Equity	No data	No data	No data
South Korea	Korea SME Credit Guarantee Fund	Equity	Guarantee fee 0.5–3% annual rate of outstanding amount. Payment of fixed financing fee	Maximum KRW$3b (A$3.6m) to KRW$7b (A$8.4m)	No data
UK	Funding for Lending Scheme	Debt and Equity	No data	No data	No data
USA	Small Business Investment Company	Debt and Equity	Loan interest 9–16%. Equity interest 10–14%	Loans from US$250k to US $10m. Investments US$100k to US $5m	Up to 7 years
USA	Small Business loans from SBA	Debt	Base rate interest + allowable spread – up to 2.75% on loans over 7 years + Guarantee Fee based on loan maturity and $ amount	Maximum US$5m	No data
Venture Capital					
Denmark	Danish Growth Fund	Equity	Interest rate set by lending bank at higher rate. 0.5% establishment fee.	Minimum DKK$1m. (A$216k)	No data
Israel	YOZMA Venture Fund	Equity	Sound business plan, not easily duplicated technology	Up to NIS$6m	No data
Singapore	Venture Debt Program	Equity	Interest rate set by lending bank. Loan may be bundled with equity purchase rights to offset risk.	Up to S$5m for each expansion	No data
Ireland	Enterprise Ireland	Equity	Must create minimum 10 jobs and €1m in one year	No more than 50% of total funds committed	Approx. 5 years
Business Angels					
Global	Business Angel Networks	Equity	Ranges from shares in company, tax offsets for investment to controlling interest	From $25k–25m depending on network and business venture	Approx. 2–7 years

Appendix C: Preferred initiatives

Jurisdiction	Initiative	Type	Owner	Amount	Ease of access	Security
Canada	Canada Small Business Financing Program	Up to C$350k for leasehold improvements, equipment, and up to C$500k for property. Maximum of C$1m for any one borrower	Public private partnership	Maximum of C$1m for any one borrower	SME approaches banks, credit unions and other financial institutions with business proposal to access finance. Small business with gross revenue of C$10m or less – eligible for loans. Financial institutions responsible for loan approval	Loan security – lenders take security on assets being financed
Canada	Business Development Canada		Government corporation	C$100,000 and above	SMEs apply online. Loans up to C$100k can be accessed within five days	Look at more than just assets – base credit decision on project's viability, management strength, and cash flow from business operations
Europe	European Investment Fund Competitiveness of enterprises and Small and Medium-sized Enterprises (COSME) Financial Instruments	Three programs – €25,000 (Micro), up to €150,000 (COSME), €25,000 to €7.5m (InnovFin)	Public private partnership	From €25,000 to €7.5m	Easy access as SMEs approach their local, regional/national authorities/banks. SMEs should not operate in EIF restricted sectors, e.g. illegal economic activities, tobacco/distilled alcohol, weapons productions/trade, casinos. SME needs to be less than 250 employees, up to €50m turnover or up to €43m balance sheet.	Decision to fund/approval and financing conditions (amount, duration, interest rate and fees) up to financial intermediary – banks could ask for collateral from SMEs but rely more on EIF guarantees

Jurisdiction	Initiative	Type	Owner	Amount	Ease of access	Security
Europe	Finnvera Growth Fund	Various –entrepreneur, internationalisation (loan or guarantee), growth, finance (loans, credit and guarantees) for variety of needs e.g. domestic construction, energy and environment projects, working capital	State owned government fund	Minimum €10,000 and no maximum specified	Financial decisions undertaken by Finnvera	Negotiated on case by case basis
Germany	KfW	20–25 different loan types	State owned promotional national bank	Up to €5-10m	SMEs apply for finance via existing commercial banks	Commercial banks perform risk assessment based on relationship with customer, business plan and key targets provided by the SMEs
UK	British Growth Fund	Long-term, patient capital – three programs: Ventures, Growth, Quoted	Privately owned	£1–10m (Growth), £1–6m (Venture)	Only invests in UK and Irish businesses. Financial information, business plan and pitch to investors	Take a minority equity stake (10–40%) in growing companies. Minority equity stake (10–20%) for high-growth ventures
UK	British Business Bank	4 programs – Start-up loans, Help to Grow, Enterprise Finance Guarantee facility, Equity funding	Government owned (independently managed)	From £500k–2m	Business Finance Guide – advises finance options from start-up to growth 94% of support outside big four banks e.g. non-bank lenders, smaller banks, alternative lenders and equity investors (flexible approach to access for SMEs)	Does not require security collateral. Help to Grow – secured on business assets at higher interest rates. Flexibility to delay interest payments to suit business circumstances

Jurisdiction	Initiative	Type	Owner	Amount	Ease of access	Security
US	Small Business Investment Capital	SBIC program targeting access to capital for growth stage business.	Privately owned	From $250k–$10m (Loans), From $100k–$5m (Equity), From $250k–$10m (Debt with equity)	Business must be mature, profitable with enough cash flow to pay interest, have at least 51% of employees and assets in the US, qualify as a SME, be an approved industry, prepare a business plan to pitch to investors. For every US$1 invested by private investors, the SBA puts in US$2. The SBIC then investments the total (US$3) into SMEs.	Not listed. However, business plan and interview with investment panel will determine outcome of application. Mature business with sufficient cash flow to pay back deferred interest loan (lump sum at the end of the term) a requirement. SBICs also gain a share of the business and a controlling interest for up to seven years to maintain the portfolio
US	Small Business Lending Fund (SBA)	Provide tier one capital to qualified community banks	US Department of Treasury	Up to US$10m to businesses	Submit small business lending plan to appropriate federal banking agency, describe how business strategy and operating goals allow it to address needs of small business in areas it serves.	Portion of any loans guaranteed by government, or for which risk is assumed by third party, is subtracted from that amount
US	Small Business Administration (SBA)	6 programs –Standard 7(a) (up to US$5m), 7(a) Small Loan (up to US$350k), SBA Express (up to US $350k); Export Express (up to US $500k); Export Working Capital (up to US$5m), International Trade (up to US $5m)	State owned	Up to US $5m dependent on loan type	To be eligible the business must operate for profit, be engaged in or propose to do business in the US, have reasonable owner equity to invest, use alternative financial resources (including personal assets) before seeking financial assistance.	SBA guarantees between 50–85% of loans taken under these programs. Lenders take no security for loans up to US$25k. For standard loans over US $350k – lender requires security over fixed business assets, trading assets and personal real estate. For small loans between US$25k to US $350k – lender takes priority mortgage over assets securing the loan including real estate. Export loans require export-related inventory and receivables generated by export sales

Appendix C: Consultations

ADI

HSBC
Judo Capital
Tyro Payments Limited
Westpac Banking Corporation

Data analyst

AlphaBeta Advisors
East & Partners

Entrepreneur

Memo Bottle
Retail Zoo

Government department

Australian Securities and Investment Commission (ASIC)
Clean Energy Finance Corporation (CEFC)
Department of Industry, Innovation and Science (DIIS)
Department of Jobs and Small Business
Department of Treasury
Export Finance and Insurance Corporation (EFIC)
Future Fund
JobsforNSW
NSW Department of Industry
NSW Department of Jobs
Office of the NSW Small Business Commissioner
Productivity Commission
Reserve Bank of Australia

Independent statutory authority

Innovation Science Australia

Individual

Andrew Watson
Chris Curnow
Karen Borg

Industry association

Australian Finance Industry Association (AFIA)
Certified Public Accountant (CPA)
Commercial Asset Finance Brokers Association of Australia (CAFBA)
Fintech Australia
Institute of Public Accountants
Mortgage & Finance Association of Australia
NSW Business Chamber
Tasmanian Small Business Council

International

Be The Business Initiative
British Business Bank
British Growth Fund
European Bank of Construction and Development
Export Development Canada
European Investment Fund (EIF)
HM Treasury
Kreditanstalt für Wiederaufbau (KfW)
Metro Bank
UK Department for Business, Energy and Industrial Strategy (BEIS)
UK Open Data Institute
UK Small Business Commissioner

Mortgage Broker

Ebroker
MoneyQuest

Non-bank lender

Allbridge Capital Pty Ltd and InvoiceX
Apricity Finance
Australian Equities Small Caps
Fintech Australia
Octet Finance
Scottish Pacific Business Finance
SME Cash
SME Crowdfunder

Regulator

Australian Prudential Regulation Authority

Small business

Borche Kosteski

Working group

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ASBFEO Policy Forum

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