



Small business access to finance: The evolving lending market

Research paper

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This study uses unit-record business data from the Business Longitudinal Analysis Data Environment and the European Commission and European Central Bank's Survey on the access to finance of enterprises. We are also grateful to the Australian Prudential Regulation Authority for providing aggregate business lending data that were used for some of the analysis in the report.

Executive summary

Australia's 2.4 million small and medium enterprises (SMEs) make a major economic contribution. Outside of the finance, insurance and public services sectors, SMEs employ about two-thirds of workers and generate more than half of Australia's value added. It is therefore important for the performance of the Australian economy that SMEs can readily obtain finance to support their day-to-day operations and fund their growth.

Australian SMEs prefer debt finance: they are three times more likely to apply for debt than equity finance. Every year, about one in six SMEs applies for finance. Most SMEs seeking debt finance apply, successfully, to the Australian banks. More than 90 per cent of the outstanding debt owed by SMEs is held by banks.¹

However, there is a persistent view that banks prefer secured lending to less-risky borrowers — home buyers and larger businesses — and have little appetite for unsecured lending to SMEs. Surveys report that almost one in five SME owners state that a lack of finance hampers their business.² These responses suggest that credit constraints on SMEs may be a significant drag on the Australian economy.

While some SME owners worry about their access to finance, a surge of new lenders and products into the market appears to be rapidly changing the options for SMEs. Some of these options rely on emerging technologies that help lenders quickly assess the creditworthiness of SMEs. Combining new data sources with innovative analytical tools (such as artificial intelligence and machine learning) has given many lenders the information and confidence to lend to SMEs without the security of property. In other cases, lenders have taken a more traditional relationship-banking approach, providing tailored services that were once the hallmark of the banks.

Regulation has shaped the evolution of the SME lending market. Changes to prudential rules have made lending to SMEs less attractive for the major banks, creating opportunities for new and established non-bank lenders. Regulation of business-to-business lending is relatively light-handed and has facilitated the entry of new players. Government initiatives to promote data sharing, such as comprehensive credit reporting and the Consumer Data Right, help provide lenders with timely information for credit assessments. Fintech lenders, for example, can quickly approve modest, short-term loans for SMEs.

The cumulative effect of these changes is a broader range of lending options beyond traditional property-secured loans for SMEs (table 1). These options include borrowing against alternative collateral — such as vehicles, machinery and intangible assets (for example, invoices and other expected receipts) — and unsecured lending. Some products are new, while others were niche products that are now widely available to SMEs.

While the SME market is well covered by various lenders and products, there appears to be a gap for *unsecured* finance between \$250 000 and \$5 million, with few lenders willing to offer these loans. The Commission has not identified any regulatory barriers that prevent willing borrowers and lenders from reaching a deal in this segment. It is likely that this gap stems from commercial realities. With a broad range of assets accepted as security, many lenders will be cautious about lending large amounts without some form of security. The due diligence required of lenders to manage their risks, where possible, may be too costly for mid-sized loans. SMEs may also be unwilling or unable to pay a sufficiently high, risk-adjusted premium for entirely unsecured lending.

¹ Based on the Australian Prudential Regulation Authority's economic and financial statistics, which collects data from lenders with greater than \$2 billion in total business credit. A total of \$423 billion of outstanding SME lending was reported as at April 2021. While this captures the vast majority of business lending, the threshold will likely exclude some newer lenders that have smaller loan books, such as fintech lenders.

² These surveys ask about the factors that businesses perceive to be hampering their activities, rather than whether businesses actually sought — and were denied — finance.

**Table 1 – Lending products available to SMEs seeking finance
By type of security, September 2021**

| Security | Typical loan sizes | Typical loan terms | Typical interest rates |
|--|---|---|---|
| Residential property | From \$10 000, representing up to 80 per cent loan-to-value ratio (LVR) | 1–30 years | Slightly less than 4 per cent |
| Commercial property | From \$10 000, representing up to 70 per cent LVR | 1–25 years | Additional 0.3–2 per cent margin relative to residential property, to reflect higher risk |
| Physical business assets | From \$5000, depending on equipment value | 1–7 years, cannot exceed asset's useful life | From 3 per cent, depending on equipment and creditworthiness |
| Other business assets^a | No or very high maximums, offered as an increasing line of credit as receivables grow, up to 95 per cent of their value | Generally short-term, such as 30–90 days per advance as part of a one-year contract | From 5 per cent, depending on the product and creditworthiness |
| Unsecured^b | \$5000–\$250 000, based on creditworthiness | 3–36 months | 15–35 per cent |
| | From \$5 000 000, based on cash flow | Highly dependent on the borrower and deal | Highly dependent on the borrower and deal |

a. Other business assets are predominantly invoices, but can also include other expected receipts such as future tax credits and non-receivables such as patents. **b.** Unsecured loans to SMEs are typically covered by a personal guarantee or general security agreement with a business owner or director.

Source: based on Commission consultations and a desktop scan of publicly available information as at September 2021. Sources include Bank of Sydney (nd); CBA (2020a, 2020b); Earlypay (nd); FundingPro (2020); ING (2019); Moula (2021); Pepper Money (nd); Prospa (2021); RBA (2021); Scottish Pacific (2021); Suncorp (2021); Westpac (nd, nd).

The recent developments in Australia's SME lending market are very significant. For some SMEs, the new lending options offer more convenience and allow them to respond quickly to business opportunities that might otherwise pass them by. For others, borrowing without property collateral may allow them to take entrepreneurial risks to innovate and grow their business. And, for some SMEs, the new options may mean that borrowing has finally become possible, as better information has allowed them to be distinguished from less creditworthy firms. More flexible options can only make prudent SMEs better off but, for a small number of firms, it might lead to taking on imprudent levels of debt.

How much SMEs benefit from these market developments will depend on several factors. One is the relatively small and underdeveloped funding market for newer lenders in Australia, which may constrain lending to SMEs. This issue has been recognised with recent government initiatives focusing on expanding the pool of available capital through securitisation.

Another factor is SME owners' limited awareness of the suite of lending options in the market. Some owners may anticipate difficulties in obtaining finance despite suitable offerings being available. Brokers with up-to-date market knowledge can help educate SME borrowers and match them with appropriate lending options.

As Australia's SME lending market continues to evolve, more accessible data for prospective borrowers and policy makers would improve market understanding. This could include more comprehensive data on business lending, particularly by smaller lenders, to examine market developments in further detail.

1. Why this study?

Key points

- ✳️ **Australia's 2.4 million small and medium enterprises (SMEs) make a significant economic contribution. Excluding the finance, insurance and public services industries, in June 2020:**
 - SMEs employed more than 7.4 million workers (about two-thirds of employment outside of these industries)
 - SMEs produced about \$700 billion in value added (54 per cent of value added outside of these industries).
- ✳️ **Given this economic contribution, it is important that SMEs can readily obtain finance.**
- ✳️ **SMEs typically rely on debt finance, being about three times more likely to seek debt than equity finance.**
 - 15 per cent of SMEs applied for debt finance in 2018-19. Larger SMEs, and SMEs in the agriculture and mining industries, had higher application rates.
 - The most common reasons for seeking debt finance were to maintain short-term cash flow (cited by 47 per cent of SMEs that sought debt finance) and to replace or upgrade existing capital stock (41 per cent).
- ✳️ **This study adds to the literature on SME access to finance by examining how the evolving lending market, including the recent proliferation of new products and providers, is affecting the availability of credit for Australian SMEs.**

1.1 SMEs are a large part of the economy

There were more than 2.4 million small and medium enterprises (SMEs) in Australia in June 2020, defined as businesses with fewer than 200 employees (box 1.1). Their operations spanned all sectors of the economy, with the largest number of SMEs found in the construction, professional services and real estate services industries. SMEs are the most common type of business in every industry in the economy, representing about 99 per cent of total businesses in almost all industries (figure 1.1). Moreover, most SMEs are on the small — rather than medium — end of the spectrum of business size.

SMEs (defined as businesses with fewer than 200 employees and excluding the financial and insurance services industry and public sector activity) employed more than 7.4 million workers in June 2020, which represented about two-thirds of employees in these industries. There is significant variation from industry to industry, ranging from 23 per cent of workers in the mining industry to 96 per cent of workers in the agriculture, forestry and fishing industry (figure 1.2). In most industries, more people are employed by small businesses than medium-sized businesses.

Box 1.1 – What is a SME?

There are numerous ways to classify businesses as small and medium enterprises (SMEs). The ABS's employment-based classification defines SMEs as businesses with fewer than 200 employees. An alternative turnover-based definition is used by the Australian Prudential Regulation Authority (APRA), whereby SMEs are businesses with turnover of less than \$50 million.

Several other organisations have different definitions for small businesses that do not capture medium-sized firms. These are used largely for regulatory and compliance purposes, with small businesses typically receiving exemptions or other concessional treatment.

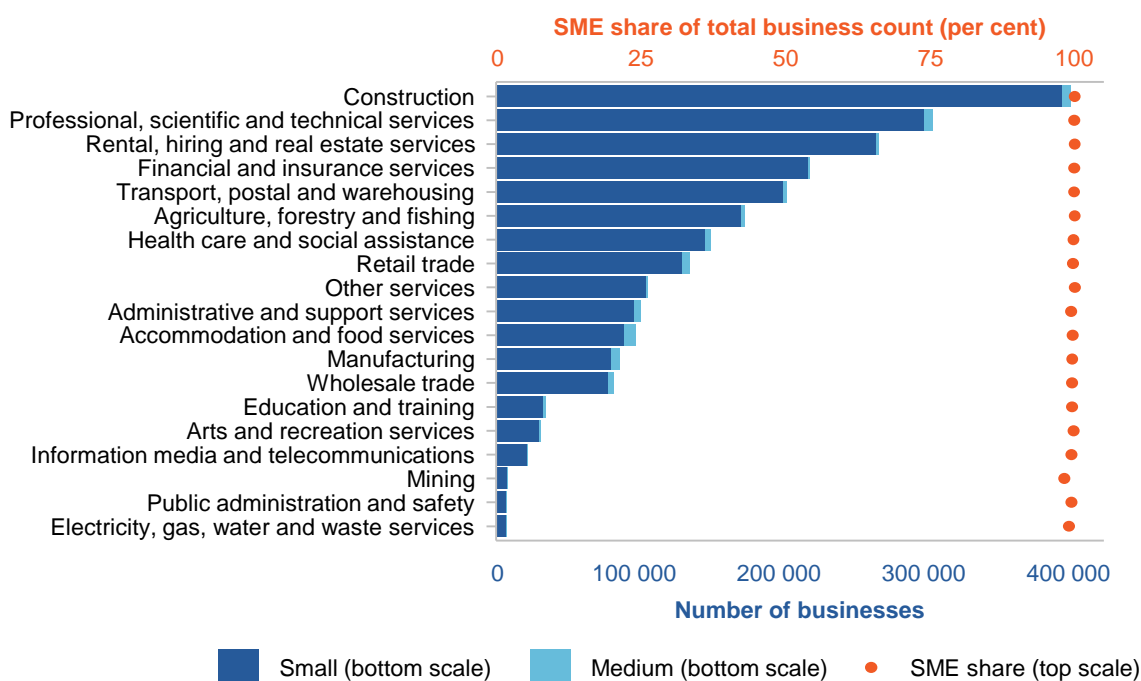
- The Australian Taxation Office defines a 'small business entity' as one with turnover of less than \$10 million.
- The Australian Securities and Investments Commission defines a 'small proprietary company' as one that satisfies at least two of the following three conditions: consolidated turnover of less than \$50 million, consolidated gross assets of less than \$25 million or fewer than 100 employees.
- The Fair Work Commission defines a 'small business employer' as one with fewer than 15 employees.

Unless otherwise specified, the analysis in this study uses APRA's definition of SMEs as businesses with turnover of less than \$50 million. This ensures that the business-level analysis of SME access to finance using the Business Longitudinal Analysis Data Environment is undertaken on a consistent basis to APRA's aggregate statistics on lending to SMEs.

Source: ABS (2021); APRA (2017); ASIC (2021); ATO (2017); FWC (2021).

Figure 1.1 – SMEs are the most common type of business in all industries

Number of SMEs by industry, June 2020^a

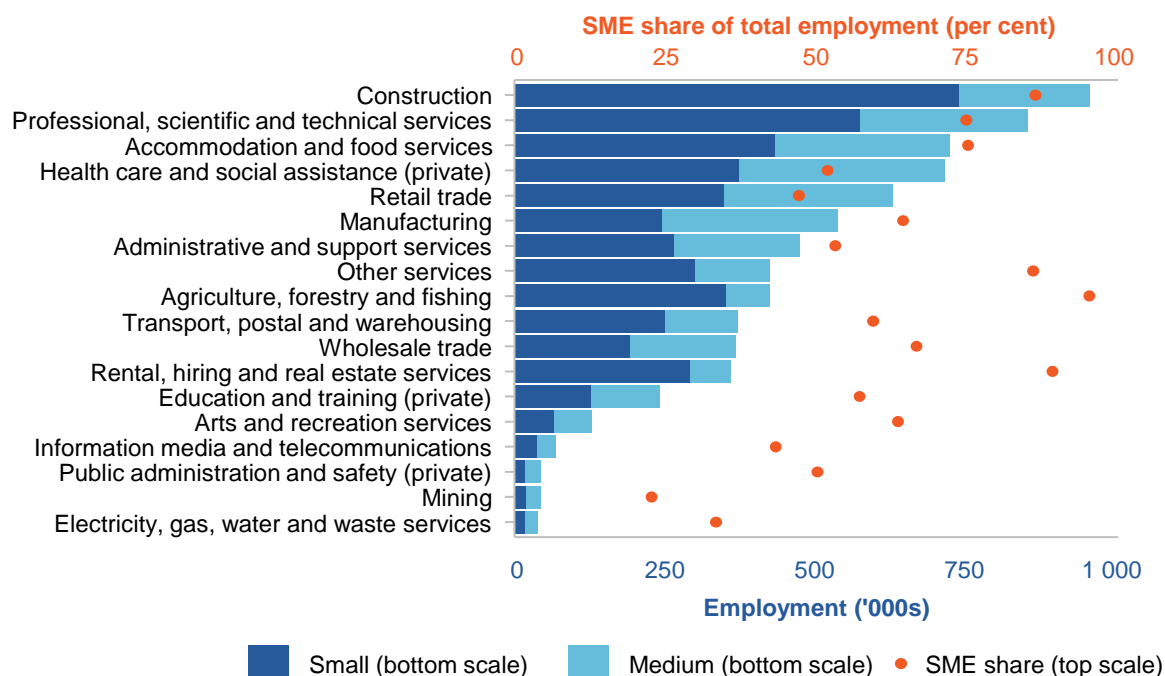


a. Small and medium enterprises are defined as those with 0-19 and 20-199 employees, respectively.

Source: Commission estimates using data from the ABS (*Counts of Australian Businesses, including Entries and Exits, June 2016 to June 2020*, Cat. no. 8165.0).

Figure 1.2 – SMEs employ two-thirds of Australian workers

Number of people employed by SMEs by selected industries, June 2020^{a,b}



a. Small and medium enterprises are defined as those with 0-19 and 20-199 employees, respectively. **b.** Excludes the financial and insurance services industry; and only captures private sector activity in the health care and social assistance, education and training, and public administration and safety industries.

Source: Commission estimates using data from the ABS (*Australian Industry, 2019-20*, Cat. no. 8155.0).

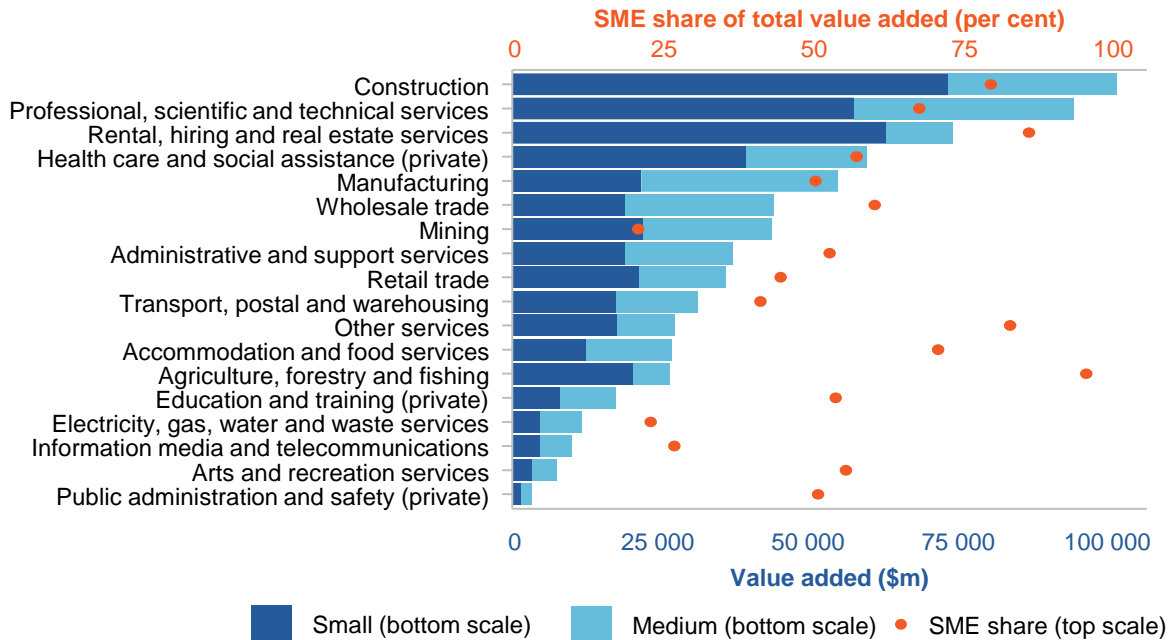
SMEs also generate a significant proportion of Australia's economic activity. Value added by SMEs (defined as businesses with fewer than 200 employees and excluding the financial and insurance services industry and public sector activity) was approximately \$700 billion as at June 2020, or 54 per cent of all businesses in these industries. This also varied across industries, with SME contributions to value added ranging from 21 per cent in the mining industry to 96 per cent in the agriculture, forestry and fishing industry (figure 1.3).

Using the Australian Prudential Regulation Authority's (APRA's) definition of SMEs as businesses with turnover of less than \$50 million (box 1.1), SMEs are typically much younger than larger firms and hold significantly lower levels of assets and debt (figure 1.4).³ In addition, the size of loans demanded by SMEs are typically smaller — for example, the average size of new fixed-term loans issued to SMEs in the year to April 2021 was about \$309 000, compared to over \$12 million for large businesses (Commission estimates using unpublished APRA data).

³ Analysis using the Business Longitudinal Analysis Data Environment to compare the APRA and ABS definitions of SMEs finds that the typical characteristics of businesses with turnover of less than \$50 million are broadly similar to those with fewer than 200 employees. In 2018-19, businesses with fewer than 200 employees had a median age of 10 years, workforce of 0 employees (that is, were non-employing), turnover of about \$85 000, assets of about \$219 000 and debt of about \$132 000.

Figure 1.3 – SMEs generate more than half of Australia’s value added

Value added by SMEs by selected industries, June 2020^{a,b}

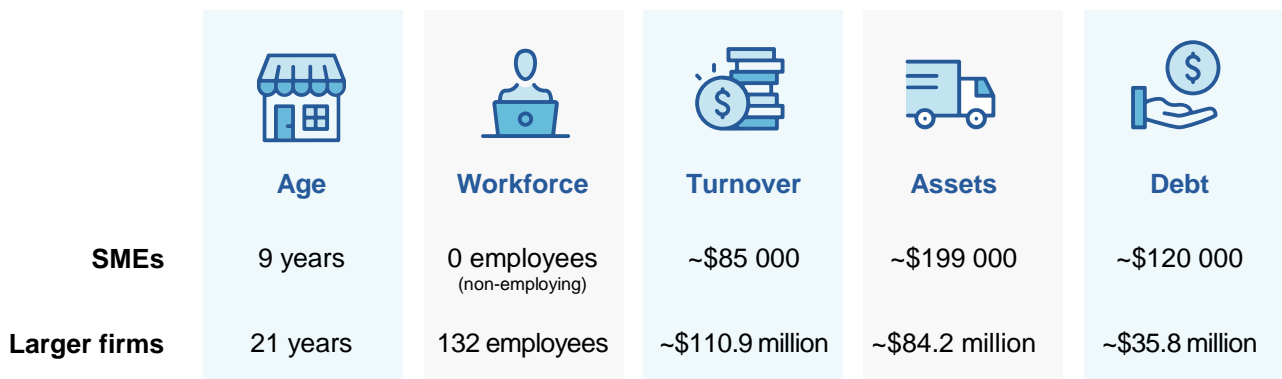


a. Small and medium enterprises are defined as those with 0-19 and 20-199 employees, respectively. b. Excludes the financial and insurance services industry; and only captures private sector activity in the health care and social assistance, education and training, and public administration and safety industries.

Source: Commission estimates using data from the ABS (*Australian Industry, 2019-20*, Cat. no. 8155.0).

Figure 1.4 – SMEs are typically younger, with lower assets and debt than larger firms

Median values for selected characteristics by business size, 2018-19^a



a. SMEs are businesses with turnover of less than \$50 million; larger firms are businesses with turnover of \$50 million or more.

Source: Commission estimates using the ABS Business Register, pay as you go summaries and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

1.2 SMEs prefer debt over equity, and have diverse needs

As SMEs represent a significant share of Australia's economic activity, it is important that these businesses can access finance to support their day-to-day operations and fund their growth. This includes, for example, working capital to pay for goods before sales revenue is received, or funds for additional staff and space if a business is expanding. If businesses cannot generate sufficient funds to meet these needs from internal sources — including the owner's capital and retained profits — they may seek finance from external parties, such as lenders or investors. Limited access to finance could hamper these activities and ultimately hurt Australia's productivity and wellbeing.

It is generally acknowledged that SMEs are more likely than larger firms to face challenges obtaining finance (Bańkowska, Ferrando and Garcia 2020; Connolly and Bank 2018; EIB 2021). Providing finance is always subject to some degree of information asymmetry: businesses know more about their operations than lenders and investors and have an incentive to only reveal information that would improve their access to finance. Smaller businesses — particularly those that are not subject to reporting requirements, such as sole traders and unincorporated enterprises — can be less transparent or more exposed to volatility than larger firms, creating more uncertainty and risk for lenders and investors.

This study focuses on SMEs' access to debt finance, which is the more common option sought by SMEs needing external finance. About 15 per cent of Australian SMEs applied for debt finance in 2018-19, compared to only 5 per cent applying for equity finance (Commission estimates using the Business Characteristics Survey and business income tax datasets in the BLADE; appendix B.1 provides details). Debt finance application rates varied depending on businesses' size and industries.

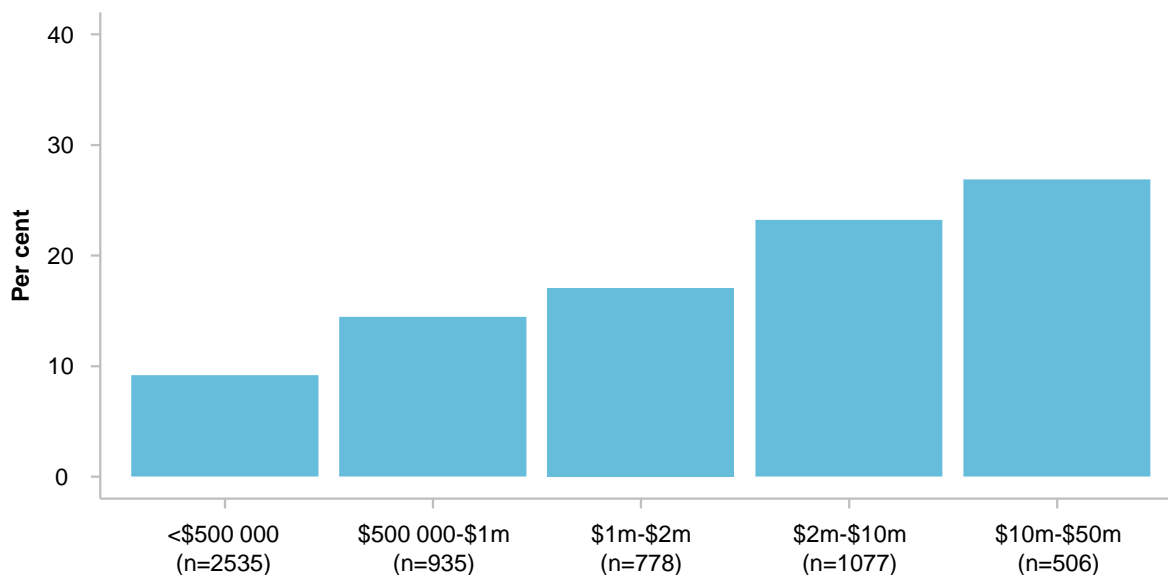
- Larger SMEs had higher application rates than smaller SMEs; for example, 9 per cent of SMEs with less than \$500 000 turnover applied for debt finance in 2018-19, compared to 27 per cent of SMEs with turnover between \$10 million and \$50 million (figure 1.5).^{4,5}
- SMEs operating in primary industries (agriculture and mining) had the highest application rates, at 23 per cent (figure 1.6). Application rates for SMEs in logistics and supply chain industries were also relatively high, at 18 per cent. Conversely, only 11 per cent of SMEs in knowledge service industries — including information, financial and professional services — applied for debt finance.

⁴ This relationship is consistent with a similar positive association observed in European countries. According to the European Commission and European Central Bank's Survey on the access to finance of enterprises, 9 per cent of European businesses with turnover of less than €500 000 applied for a bank loan in the six months to September 2019, compared with 22 per cent of those with turnover between €10 million and €50 million. SME loan application rates for each turnover category are likely to be higher over a 12-month period. Further information about these data is provided in appendix B.2.

⁵ Variations in debt finance application rates by age are broadly similar to those by turnover, as there is a moderate correlation between a SME's turnover and age. (SMEs that are higher grossing are likely to have been operating for longer; however, irrespective of age, most SMEs do not grow to be as large as over \$2 million turnover.) Application rates by SME age are provided in appendix B.1.

Figure 1.5 – Larger SMEs have higher debt finance application rates

Share of SMEs that applied for debt finance, by turnover, 2018-19^a

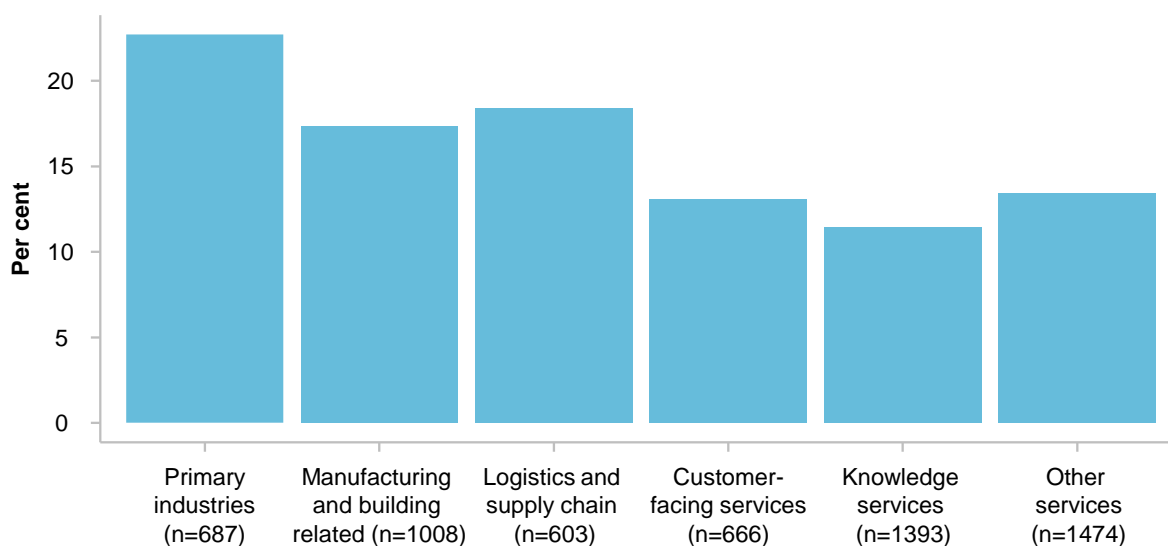


a. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Figure 1.6 – Primary and logistics industry SMEs were more likely to apply for debt finance than service industry SMEs

Share of SMEs that applied for debt finance, by industry, 2018-19^{a,b}



a. 'Primary industries' includes agriculture, forestry and fishing, and mining; 'manufacturing and building related' includes manufacturing, construction, and electricity, gas, water and waste services; 'logistics and supply chain' includes wholesale trade, and transport, postal and warehousing; 'customer-facing services' includes retail trade, and accommodation and food services; 'knowledge services' includes information media and telecommunications, financial and insurance services, and professional, scientific and technical services; 'other services' includes rental hiring and real estate services, administrative and support services, public administration and safety, education and training, health care and social assistance, arts and recreation services, and other services. b. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Australian SMEs' preference for debt over equity finance is consistent with economic theory, which observes that SMEs as well as lenders and investors will often prefer debt to equity, for different reasons (box 1.2). SME owners usually want to maintain control of their business and avoid diluting their equity. At the same time, lenders and investors can manage their risks and reduce the possibility of moral hazard by providing debt rather than equity funding.

Box 1.2 – Financing decisions and firm incentives

Economic theory suggests that where firm ownership (say, by an investor taking an equity stake) is separated from firm control (say, by the original owner or entrepreneur retaining decision-making discretion), the decision makers may deploy owners' resources towards their own objectives. For example, while the equity holder's interests are maximising returns, the entrepreneur could operate the business to achieve other goals — such as building prestige, creating innovations or pursuing growth over profitability. More insidious cases of moral hazard may also arise should the entrepreneur take purely self-interested actions after securing equity funding (such as paying themselves a large salary or putting less effort into the business), diminishing profits for equity holders.

Although these risks can apply to all equity investments, they are more relevant for small and medium enterprises (SMEs). Smaller businesses are less likely to have established governance processes (for example, public reporting requirements or policies to align owners' and decision makers' interests) and more likely to have decision-making control centralised in a single authority, such as the original entrepreneur. In practice, equity investors may overlook these risks to invest in SMEs with attractive growth and profitability prospects — for instance, venture capital investors often provide finance to innovative early-stage SMEs in exchange for an equity stake. But, even in these ventures, investors typically seek some control rights in the SME to reduce the possibility of incentive misalignment and moral hazard.

Debt finance, on the other hand, mitigates some of these issues. A SME owner who has obtained external debt finance retains ownership and control of their business. They must repay the debt according to their contract with the lender but, as they are the sole beneficiary of their decisions and actions, lenders can be less concerned about incentive misalignment. However, there still could be some risk of moral hazard as corporate insolvency law places some limits on the downside for the SME owner in the event of business failure, which could result in them selecting riskier projects than a lender believes is optimal.

Source: Colombo and Delmastro (2004); Hall et al. (1993); Hellmann (1998); Marris (1964); Schwiendbacher and Larralde (2010); Williamson (1964).

SMEs apply for debt finance for a range of business purposes. The most common reason is to maintain short-term cash flow or liquidity, cited by 47 per cent of SMEs that sought debt finance in 2018-19 (figure 1.7).⁶ The second most common reason is replacing or upgrading capital stock such as equipment, machinery or IT hardware (41 per cent).

⁶ Further information on how the purpose for applying for debt finance varied by SME characteristics (including their size and industry) can be found in appendix B.1.

In 2017-18, 47 per cent of SMEs that sought debt finance applied for a short-term product — which includes credit cards, overdrafts, and loans and lines of credit with a term of one year or less (figure 1.8).⁷ Meanwhile, 42 per cent applied for a capital lease or hire purchase agreement, and 39 per cent for a longer-term loan — which includes mortgages and other loans with a term of more than one year. Different debt products lend themselves to different borrowing amounts: the average size of new fixed-term loans (both short and long term) issued to SMEs in the year to April 2021 was \$309 000, while average amounts borrowed under new finance leases and credit cards were \$120 000 and \$25 000, respectively (Commission estimates using unpublished APRA data).

Figure 1.7 – Maintaining cash flow and replacing capital were the most common reasons for needing debt finance

Share of SMEs citing each reason for applying for debt finance (of all SMEs that applied for debt finance), 2018-19^{a,b}



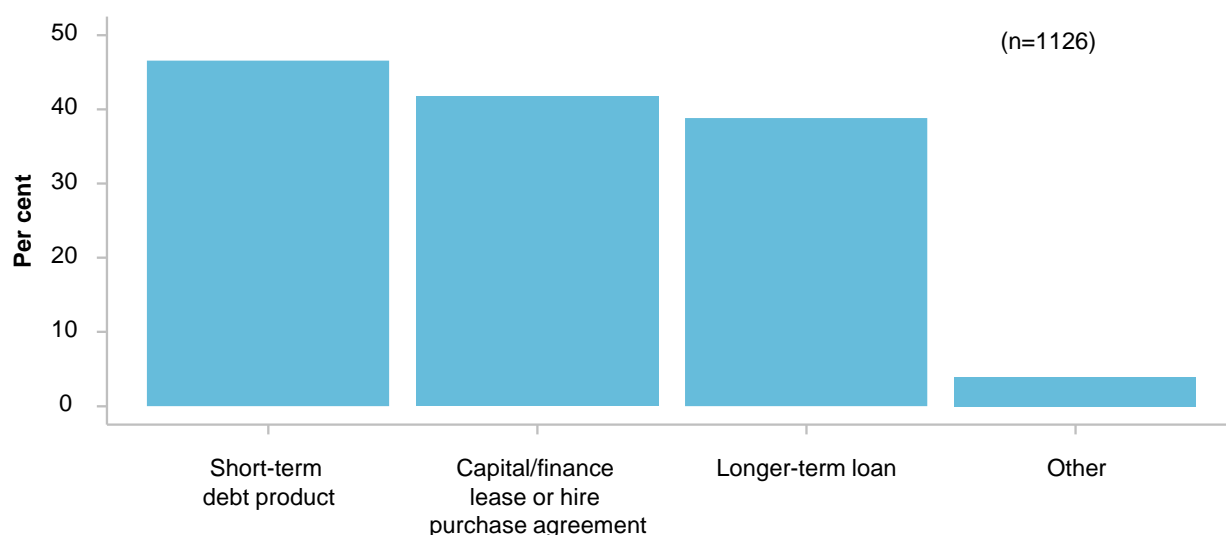
a. SMEs could select one or more reasons for applying for debt finance. b. n is the total number of SMEs for which this question was relevant (that is, the number of SMEs in the sample that applied for debt finance).

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

⁷ Further information on how the product applied for varied by SME characteristics (including their size and purpose for applying for finance) can be found in appendix B.1.

Figure 1.8 – Various debt products are used

Share of SMEs that applied for each debt product (of all SMEs that applied for debt finance), 2017-18^{a,b,c}



a. SMEs could apply for one or more debt products. **b.** ‘Short-term debt products’ contain bank overdrafts, loans with a term of one year or less (including lines of credit), credit cards and increases in amount of existing credit facilities and limits. ‘Longer-term loans’ contain loans with a term of more than one year and mortgage loans. **c.** n is the total number of SMEs for which this question was relevant (that is, the number of SMEs in the sample that applied for debt finance).

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

1.3 This study examines the evolving SME lending market

This study will consider how SMEs access debt finance in Australia. It focuses on the medium-term trends that are changing the market rather than the temporary disruptions due to COVID-19. Access to finance will be an important facilitator of the economic recovery as surviving and new SMEs seek funding to invest and expand (Bank and Lewis 2021).

The study focuses on three key research questions about the market and how SMEs can access finance in Australia.

- What options are available to SMEs seeking debt finance?
- How has the SME lending market changed with the recent emergence of new products and lenders?
- Is the market functioning well? Are there regulatory barriers or other factors inhibiting lending activity and SME access to finance?

Access to finance has been studied in the past, with mixed findings on whether there are barriers preventing SMEs obtaining credit. These views, and the traditional SME lending landscape more broadly, are discussed in chapter 2.

Over recent years, the Australian lending market has seen significant changes with new products and providers (including non-bank lenders) emerging. There is a need to update the previous research on SME access to finance in light of these developments. In this context, chapter 3 examines how market developments — such as regulatory and technological changes — have created opportunities for both new and existing lenders, leading to more lending options for SMEs and potentially easing credit constraints. And chapter 4 discusses some implications and the potential for future growth in the SME lending market.

2. The traditional SME lending landscape

Key points

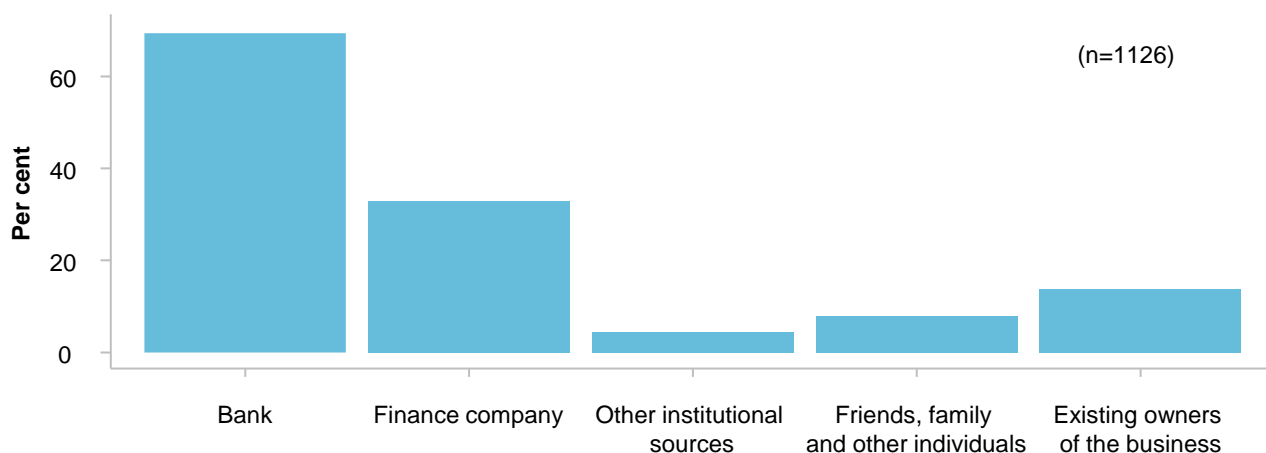
- * **Banks are the main source of finance for small and medium enterprises (SMEs) in Australia.**
 - The majority (69 per cent) of SMEs that sought debt finance in 2017-18 applied to banks.
 - Authorised deposit-taking institutions (which are mostly banks) had issued 91 per cent of the \$423 billion of total outstanding lending to SMEs as at April 2021.
- * **Banks have traditionally concentrated on less-risky market segments, with much of their lending secured by property as collateral. About half of all outstanding lending to small businesses in Australia is secured by residential property.**
- * **Most SMEs seeking finance obtain it: 84 per cent of SMEs that applied for debt finance in 2018-19 were successful.**
- * **While debt finance application success rates are high, some stakeholders report that SMEs face challenges in obtaining finance.**
 - One concern is that banks' market dominance and their preference for lower-risk secured lending deters SMEs lacking property assets from applying for finance. The data show that SMEs with more assets are more likely to apply for and obtain debt finance, but this also reflects that businesses requiring large asset bases (in certain industries, for instance) have greater need to fund these investments.
 - Another concern is that the cost of finance for SMEs is prohibitive, as interest rates on SME loans are typically higher than the rates paid by larger businesses. However, this reflects the higher risk associated with SME lending — modelling by major banks suggests that small businesses are more than twice as likely as large businesses to default. Interest rates on all business debt have significantly declined over the past decade.

2.1 Secured lending by banks is a significant part of the market

Banks have historically dominated the Australian lending market and are the main source of finance for small and medium enterprises (SMEs). Given the long-established position of banks in Australia's financial services industry and the likelihood that SME owners seeking debt already have existing relationships with banks, such as for personal finance — it is not surprising that banks provide most SME lending.

Most SMEs (69 per cent) seeking debt finance in 2017-18 applied to banks (figure 2.1).⁸ And of the \$423 billion of total outstanding lending to SMEs reported to the Australian Prudential Regulation Authority (APRA) as at April 2021, 91 per cent by value was issued by authorised deposit-taking institutions (ADIs), which are mostly banks (figure 2.2; note that this figure excludes some smaller lenders).⁹ There were 2.2 million outstanding SME loans as at April 2021, of which 71 per cent originated from ADIs and 29 per cent from non-ADIs (Commission estimates using unpublished APRA data).

Figure 2.1 – Banks were the most frequently approached lenders
Share of SMEs that approached each lender (of all SMEs that applied for debt finance), 2017-18^{a,b}



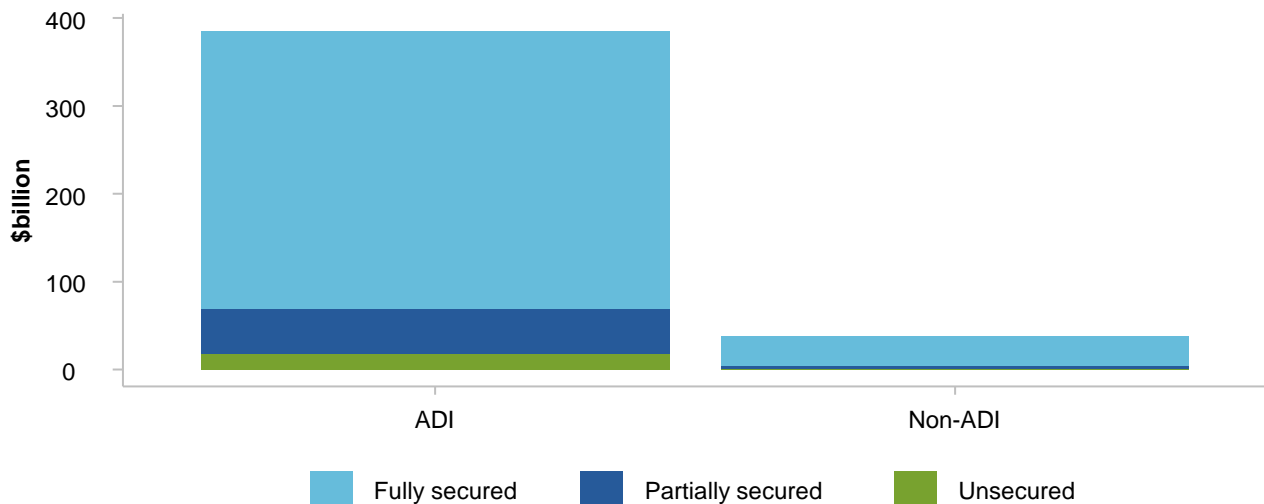
a. SMEs could approach one or more lenders. ‘Other institutional sources’ include other businesses, such as alternative lenders. **b.** n is the total number of SMEs for which this question was relevant (that is, the number of SMEs in the sample that applied for debt finance).

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

⁸ Further information on how the lender approached varied by SME characteristics (including their size and purpose for applying for finance) can be found in appendix B.1.

⁹ Outstanding finance is the original amount of credit issued less any repayments. These estimates are based on APRA’s unpublished economic and financial statistics, which have been collated since July 2019. APRA collects business lending data from ADIs and registered financial corporations with greater than \$2 billion in total business credit. While this captures the vast majority of business lending, the threshold will likely exclude some newer SME lenders that have smaller loan books, such as fintech lenders (box 3.1). These statistics also do not capture personal lending that is used for business purposes, which can occur in instances where there are blurred lines between SME owners’ personal and business finances.

Figure 2.2 – Most SME lending by value is issued by ADIs and fully secured
Value of outstanding finance to SMEs by lender and collateralisation, April 2021^{a,b}



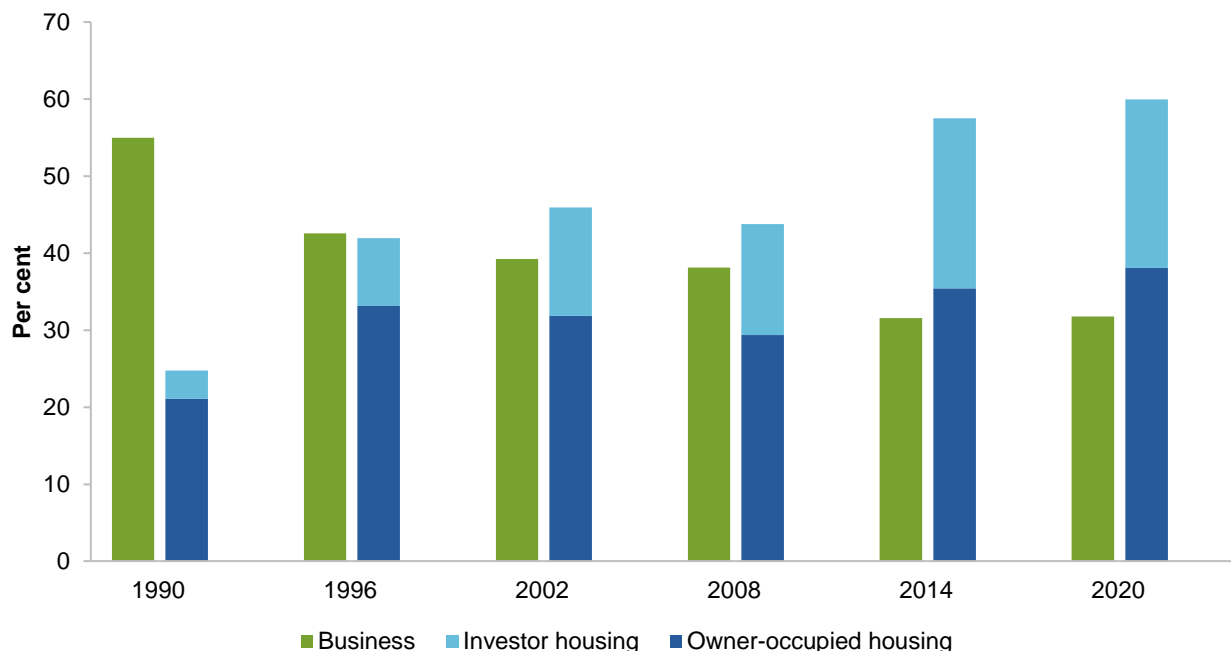
a. Lending is to resident non-related parties and includes fixed-term loans, credit cards, finance leases, bill acceptances, margin lending and other revolving facilities. Security includes various types of collateral such as property, equipment and invoices. SMEs are businesses with turnover of less than \$50 million. **b.** Data are collected from lenders with greater than \$2 billion in total business credit. While this captures the vast majority of business lending, the threshold will likely exclude some newer SME lenders that have smaller loan books. These statistics also do not capture personal lending that is used for business purposes, which can occur in instances where there are blurred lines between SME owners' personal and business finances.

Source: Commission estimates using unpublished APRA data.

Although they are the major source of finance for SMEs, banks have been shifting their focus away from business lending and toward housing loans over the past few decades. Lending to businesses represented 55 per cent of banks' lending (excluding lending to government) in 1990, but declined to 32 per cent by 2020 (figure 2.3) — the reasons for this shift are discussed further in chapter 3. However, in dollar terms, business lending has increased consistently over this period, with an average annual growth rate of 6.5 per cent between 1990 and 2020 (RBA 2021a). This was higher than the average annual growth rate of nominal gross domestic product over this period, at 5.3 per cent (ABS 2021).

Figure 2.3 – Banks have shifted away from business lending

Share of bank lending issued to each sector (excluding government), 1990 to 2020^a



a. Shares do not add to 100 per cent as other personal lending and commercial lending to financial intermediaries are not depicted.

Source: RBA (2021a).

Most SME lending in Australia is secured by some form of collateral (figure 2.2), which can be sold by the lender to recoup losses if the borrower defaults. The quality of the collateral provided affects a loan’s risk — an asset with a stable market value that is easy to liquidate is a less risky proposition for a lender. A SME may also be less likely to invest borrowed funds in an excessively risky venture if it has pledged valuable collateral.

Collateral can be provided using various assets, but property-secured loans are most common in the Australian SME market.¹⁰ The size of a property-secured loan depends on the value of the property. Loan amounts are expressed as a percentage of the value of the underlying collateral, also known as a loan-to-value ratio (LVR). For example, a SME borrower pledging a house worth \$500 000 as collateral would be able to borrow \$400 000 at a LVR of 80 per cent (assuming that there is no other mortgage on the property). A higher LVR poses a higher risk to a lender and is typically associated with a higher interest rate to compensate for this additional risk.

In Australia, about half of all outstanding lending to small businesses (by value) is secured by residential property (Kent 2021, p. 5). The prevalence of residential property-secured SME lending may be partly attributable to the persistent growth in Australian house prices. Rising prices enable home-owning SME owners to borrow more against the value of their property for a given LVR, although conversely SME lending growth can stall when house prices fall (Cranston 2019). In this context, a SME owner might use their personal home as security for a business

¹⁰ Lenders typically secure their interest in property used as collateral by issuing a mortgage. If the property already has a charge over it — for instance, if the borrower had used a mortgage to purchase the property and was still paying it off — this may take the form of a second mortgage. In the event of a default, the first mortgage holder is paid back before the second mortgage holder.

loan to obtain cheaper, long-term finance (Garner 2020). Previous research has highlighted that there can be a blurred line between the personal and business finances of SME owners, who sometimes opt to use personal debt for business purposes (Holmes and Gupta 2015, p. 38).

In addition, many lenders favour property as collateral because it maintains its value over time (Connolly, La Cava and Read 2015, p. 119). This is particularly the case for banks, which generally serve the less risky end of the SME market and therefore usually require residential property as collateral (Connolly and Bank 2018). One survey undertaken by a finance company reported that over 20 per cent of SMEs that use residential property as security do so because it is the only kind of security their lender will accept (Scottish Pacific 2020, p. 19). The former Small Business Ombudsman also noted that lenders can be reluctant to extend debt without property security (Hughes 2018).

SME loans can also be secured by commercial property. These loans have similar characteristics to loans secured by residential property. However, relative to residential property-secured loans, commercial property-secured lending is typically offered with an added margin on the interest rate charged, lower LVRs and shorter terms, to account for its somewhat higher risk (for example, commercial property values are more susceptible to economic shocks (Ellis and Naughtin 2010)). Notwithstanding this additional risk, under some circumstances SME lenders will prefer commercial property to residential property as security, such as when residential property is already mortgaged (Connolly, La Cava and Read 2015, pp. 119–120).

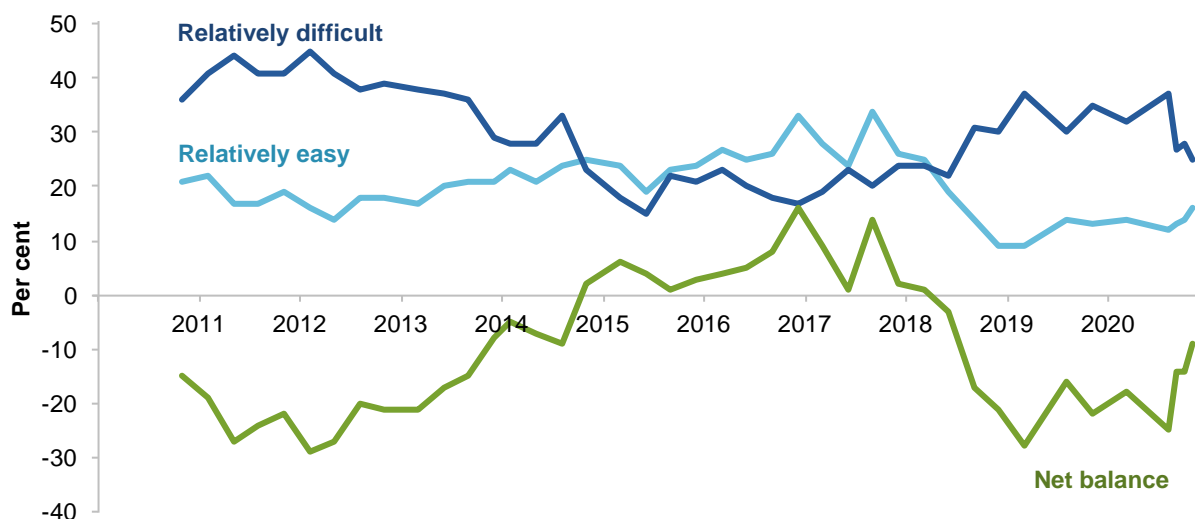
2.2 There are mixed views on access to finance

About 13 per cent of SMEs obtained debt finance in 2018-19. The vast majority of applications were successful — 84 per cent of SMEs that applied for debt finance obtained it (Commission estimates using the Business Characteristics Survey and business income tax datasets in BLADE; appendix B.1 provides details). This is consistent with banks reporting that most SMEs seeking finance are successful, with approval rates for small business loans at more than 90 per cent between 2013 and 2019 (ABA 2019, p. 15). And the high success rate in Australia is similar to patterns observed overseas — 81 per cent of European SMEs that applied for a bank loan in the six months to September 2019 were successful (Commission estimates using data from the EC/ECB SAFE).¹¹

But there are also reports that SMEs face difficulties accessing finance in Australia. The *Sensis Business Index*, which surveys a (non-representative) sample of about 1000 SMEs, suggests that SMEs' perceptions of access to finance declined between late 2017 and early 2019. The share of surveyed SMEs stating that it was relatively easy to access finance fell over this period, while the share stating that finance was relatively difficult to access increased (figure 2.4). Access to finance was perceived to have improved in the second half of 2020 — likely in part due to the government's COVID-19 response to support the flow of funds to SMEs (Bank and Lewis 2021) — although in net terms there continues to be a higher share of SMEs reporting that access to finance is relatively difficult (Sensis 2020, p. 13).

¹¹ Loan application rates appear to be higher among European SMEs than Australian SMEs. 14 per cent of European SMEs applied for a bank loan in the six months to September 2019 (Commission estimates using data from the EC/ECB SAFE). The available data for a smaller subset of European countries suggest that the SME loan application rate over the 12 months to September 2019 could be about 1.5 times the six-month rate. This indicates a higher loan application rate for European SMEs than Australian SMEs' debt finance application rate (15 per cent in 2018-19, chapter 1). However, there are factors that limit the direct comparability between the Australian and European data. Further information is provided in appendix B.2.

Figure 2.4 – A higher share of SMEs report that access to finance is relatively difficult
Share of SMEs surveyed about their perceived ability to access finance, November 2010 to November 2020^a



a. Since July 2019, surveyed SMEs have been asked about their perceived ability to access finance currently compared to two months ago. Prior to this, SMEs were asked for their assessment on access to finance at a point in time. 'Net balance' is the share of SMEs stating that it is relatively easy to access finance less the share stating that it is relatively difficult.

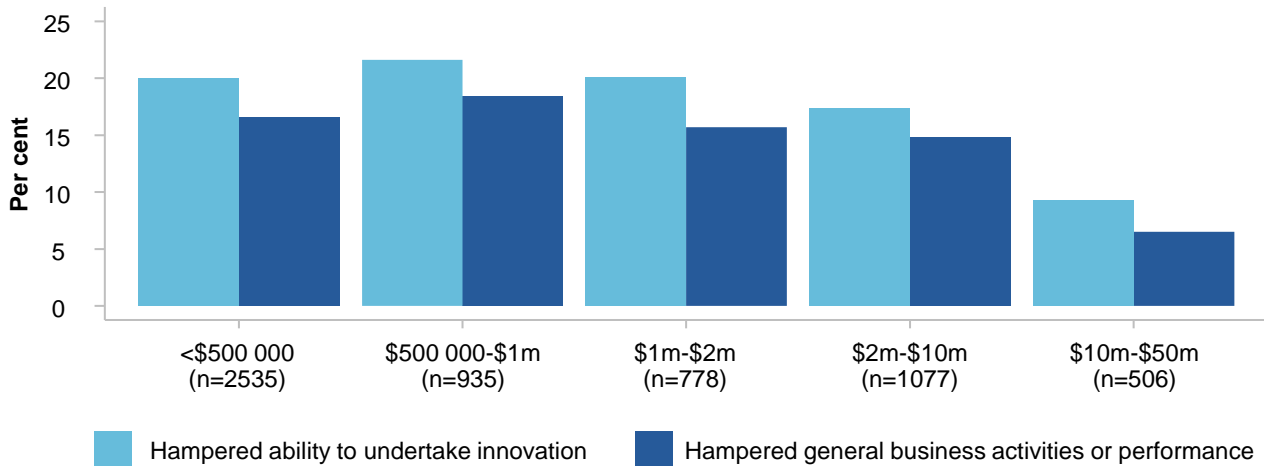
Source: *Sensis Business Index* (Sensis, various editions, accessed at: <https://www.sensis.com.au/about/sensis-business-index>).

About 16 per cent of SMEs stated that a lack of access to additional funds significantly hampered their general business activities in 2018-19 — this was a little higher than the share of SMEs nominating various other factors as barriers, such as a lack of skilled workers or a lack of demand (Commission estimates using the Business Characteristics Survey and business income tax datasets in BLADE).¹² Moreover, 19 per cent of SMEs said that a lack of funds significantly hampered their ability to undertake innovation. These shares have remained relatively unchanged over the past decade. Larger SMEs with turnover of \$10 million or more were less likely to report that lack of access to additional funds hampered their activities than smaller SMEs (figure 2.5).

¹² These shares are based on survey responses to questions regarding the factors that businesses perceive to be hampering their activities, rather than whether businesses actually sought — and were denied — finance. Further information on the various factors cited by SMEs as hampering their activities can be found in appendix B.1.

Figure 2.5 – Lack of access to additional funds was more likely to hamper smaller SMEs' activities

Share of SMEs citing lack of access to additional funds as significantly hampering their operations, by size, 2018-19^a



a. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Overall, these indicators suggest that there is a small (but not insignificant) number of SMEs that may be experiencing credit constraints. However, there is insufficient evidence to conclude whether these are creditworthy SMEs that cannot obtain finance on reasonable terms due to lending market failures. As the Productivity Commission observed in its 2018 inquiry on *Competition in the Australian Financial System*:

That not every SME applicant is successful in accessing debt finance does not necessarily indicate fundamental problems with the financial system. Rather, the below 100% success rate suggests that lenders are engaging in a rational consideration of the risks, costs and benefits involved with financing each business. If all businesses were successful in obtaining debt finance all the time, this would indicate that financial institutions and their investors were not taking into account the risks and uncertainties of financing SMEs. (PC 2018, p. 439)

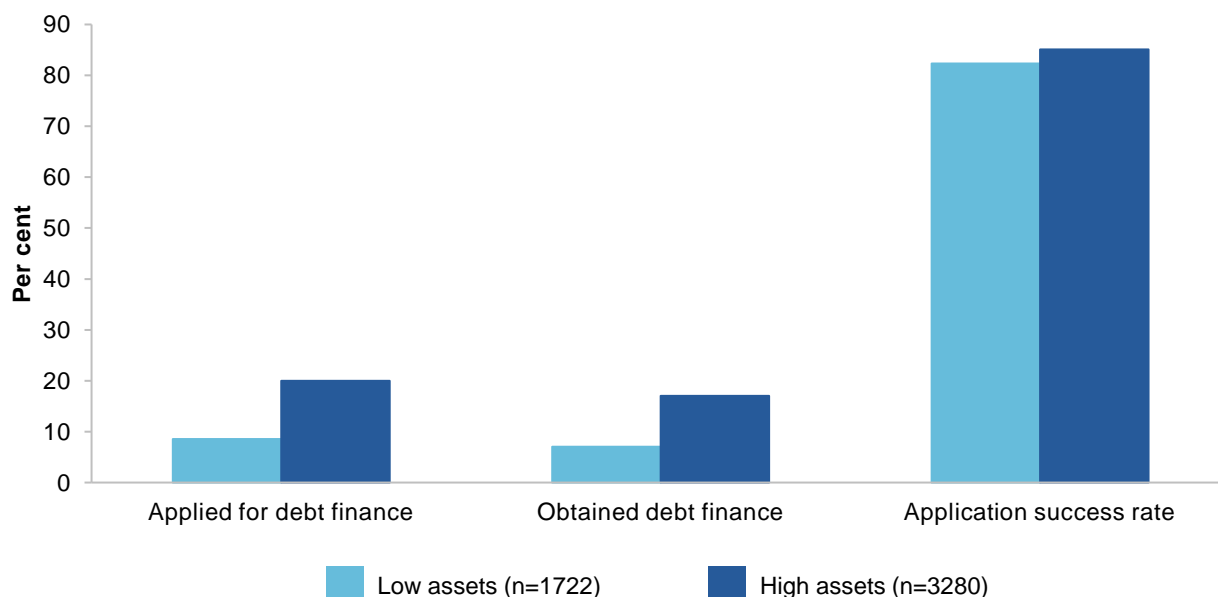
Collateral requirements and asset ownership can weigh on SME decisions ...

Some stakeholders link potential challenges with obtaining credit to banks' dominance of the SME lending market and their preference for lower-risk property-secured lending (AICD 2019). According to the OECD's *Financing SMEs and Entrepreneurs 2020* report, 'Australian SMEs are finding it more difficult to access finance through the banking system. Small businesses in the start-up or expansion phase without high quality collateral have particular difficulty accessing external finance' (OECD 2020).

SMEs with larger asset bases that can be used as collateral are indeed more likely to access credit — in 2018-19, 17 per cent of SMEs with assets above the median obtained debt finance, compared with 7 per cent

of those with below-median assets (figure 2.6).¹³ This largely reflected that the debt finance application rate for SMEs with above-median assets (20 per cent) was more than double the rate for SMEs with below-median assets (9 per cent). SMEs with more assets were also more successful in their debt finance applications, although those with less assets were still able to obtain debt with a high (82 per cent) success rate.¹⁴

Figure 2.6 – SMEs with higher assets were more likely to obtain finance
Share of SMEs that applied for and obtained debt finance, by assets, 2018-19^{a,b}



a. 'High assets' includes SMEs with asset values above the median, and 'low assets' includes SMEs with asset values below the median. SMEs with no asset information are excluded. Application success rates are the share of SMEs that obtained debt relative to those that applied for debt. **b.** n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Previous research has described a positive association between a business's asset base and its ability to access finance. For example, Araujo and Hambur (2018, p. 11) found a small positive relationship between Australian businesses' asset levels and credit application success rates, with the likelihood of success being one percentage point higher for a firm at the 75th asset percentile compared to the 25th percentile. And in the United States, Berger and Udell (1995, p. 364) found that, after controlling for other characteristics, firms with more assets were able to access lending at lower interest rates, although this effect was not statistically significant.

As secured loans from banks are the most prevalent source of finance for SMEs, some stakeholders report that businesses may be deterred from applying for finance if, for example, they do not have property assets for collateral. A survey of finance brokers found that 46 per cent of SME finance inquiries were not referred onwards to a loan application (ASBFEO 2018, p. 12) — although, apart from broker discouragement, this

¹³ It is worth bearing in mind that 'asset finance' — credit for the purpose of purchasing an asset — is widely available, so long as the asset can be easily resold in the event of financial distress (as discussed in chapter 3). Thus a SME that is borrowing in order to purchase an asset will most likely obtain a loan and also have at least one valuable asset.

¹⁴ Data on the loan sizes being sought by these SMEs and the amounts approved were unavailable in BLADE, so the extent to which higher success rates reflected better alignment between the amount of funds sought and the available asset cover is unclear.

could also be due to SMEs reassessing their need for finance after discussions with a broker. Lenders themselves may also turn away SMEs seeking debt before they commence the formal application process. As these factors are not reflected in application success rates, findings relating to SMEs that have obtained debt 'should be interpreted as providing insights into what factors are most correlated with firms' access to credit, *conditional* on them applying' (Araujo and Hambur 2018, p. 3).

... although some SMEs do not apply because they do not require credit

The Reserve Bank of Australia (RBA) has previously stated that 'of the small businesses that choose not to seek external finance, only a small proportion attributes this to an expectation that it will be difficult to obtain' (Matic, Gorajek and Stewart 2012, p. 16). This suggests that SMEs' decisions about applying for debt are more likely to be determined by their external finance needs, and these needs vary based on their activities and growth plans. For example, SMEs operating at close to full capacity and seeking to expand will typically need to invest in new capacity. The nature of this investment depends on their operations:

For firms in the more capital-intensive goods-related industries, a high level of capacity utilisation may reveal an impetus to increase employment and to invest in the capital stock, while for services firms it may reflect only an incentive to increase the use of labour. (Lane and Rosewall 2015, p. 14)

This type of expansion by services sector SMEs — such as hiring additional contractors or permanent staff — entails a smaller, incremental increase in operating expenses that requires less debt finance to fund (or potentially no external finance at all). In contrast, capital-intensive SMEs, such as those in primary industries, have a greater need for both labour and capital inputs to expand their capacity. The latter is more likely to require relatively lumpy investments, which may be funded using larger amounts of debt and therefore lead to higher debt application rates by these SMEs (as shown previously in figure 1.6).

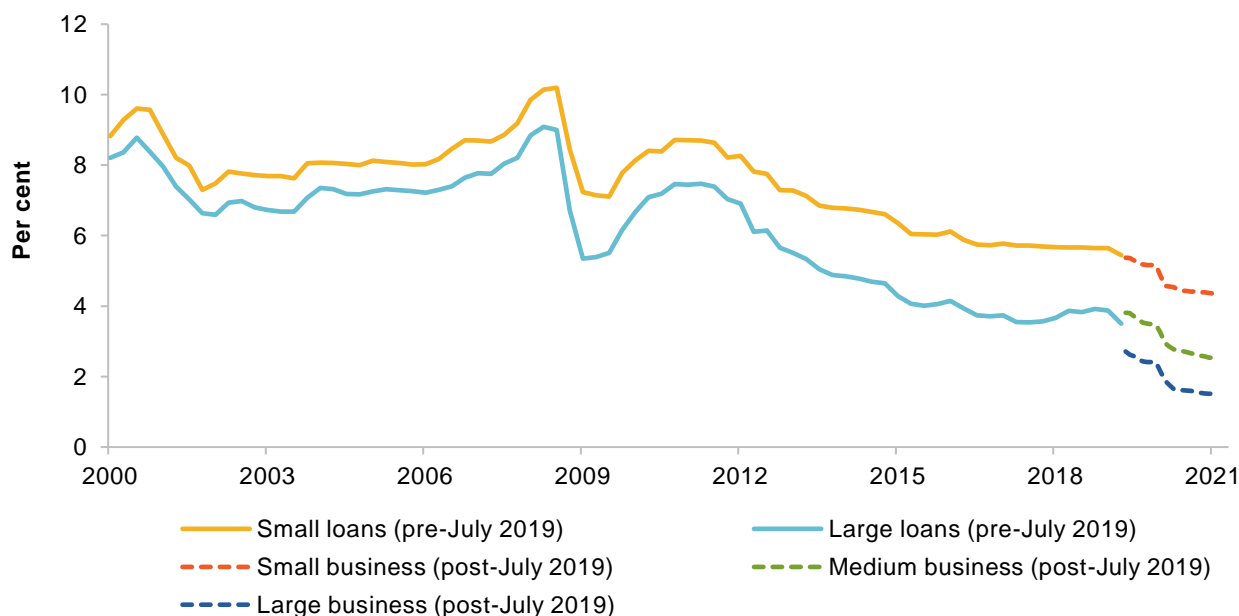
The nature of a SME's growth and how it is funded is highly specific to an individual business; for instance, not all services sector SMEs expand incrementally — some may be seeking to open another office or store in a new location, which could require large capital outlays. More generally, it is difficult to quantify the extent to which Australian SMEs with low application rates are being deterred from seeking finance, rather than not requiring finance.

SMEs also face higher lending costs than larger firms

Concerns about SME access to finance relate not only to quantity, but also to price — that is, whether creditworthy SMEs are offered finance at a reasonable cost and terms. Interest rates on business debt have significantly declined over the past decade, consistent with the broader easing of monetary policy, but small businesses pay higher interest rates than larger ones. While aggregate data on SME lending are limited before July 2019, average variable rates on outstanding small loans (business loans of less than \$2 million) fell from about 8 per cent in 2010 to 5 per cent in 2019 (figure 2.7). The cost of debt finance for both small and medium businesses has continued to decline since 2019, although the spread between the interest rates paid by small and large businesses has widened slightly over this period.

Figure 2.7 – Interest rates on SME loans have significantly declined

Average variable interest rates on outstanding business credit, by business size, March 2000 to April 2021^{a,b}



a. Before July 2019, data were reported based on loan amounts rather than business size, as APRA did not collate lending data consistently by business size. Small loans are less than \$2 million in value; large loans are greater than \$2 million in value. There was also little to no consistent data on lending by non-bank institutions in this earlier period. **b.** Since July 2019, APRA has collected more detailed business lending data for its economic and financial statistics. Small businesses are those with turnover of less than \$50 million and lending exposures of less than \$1 million; medium businesses are those with turnover of less than \$50 million and lending exposures equal to or greater than \$1 million; large businesses are those with turnover of \$50 million or more.

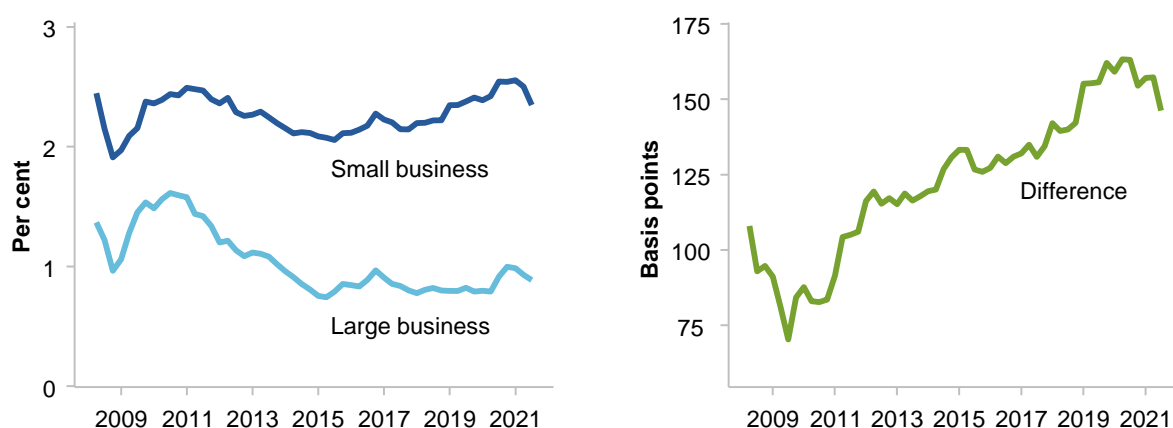
Source: RBA (2021b, 2021c).

SMEs are typically offered debt finance at higher interest rates because they are a riskier lending proposition, and credit providers require a higher return to compensate for this additional risk (or may alternatively apply more restrictive loan conditions to reduce risks). Large businesses, on average, have lower default rates — estimates constructed by the major banks suggest that small businesses are more than twice as likely to default on their loan compared with large businesses (figure 2.8). The difference between small and large businesses’ default rates has increased over the past decade.

In this context, SMEs may be able to access finance but not at the price or terms that they would like. However, the RBA recently noted that ‘small businesses have reported that the price has not been the biggest impediment to accessing finance over the past few years’ (Kent 2021, p. 11) — indeed, declining interest rates mean that fewer SMEs are likely to find that the cost of finance is prohibitively high. Banks’ collateral requirements (discussed above) and lengthy and onerous loan assessment processes were also highlighted as key challenges in accessing finance. During consultations, the Commission heard that assessment processes can sometimes take 4–5 weeks, which is not always satisfactory for SMEs (for example, those seeking finance for short-term cash flow purposes).

Figure 2.8 – Banks' models predict that small businesses are more than twice as likely to default than large businesses

Average estimated business lending default probabilities from banks' internal ratings-based models, March 2008 to June 2021^a



a. Estimates using the on-balance sheet exposures of major banks. Small business comprises the SME retail and SME corporate categories in APRA's capital framework; large business is the corporate category.

Source: unpublished APRA data.

Overall, no definitive answer can be reached as to whether inefficient credit constraints exist. The characteristics of SMEs that obtain finance suggest that larger SMEs with more assets are more likely to be successful, but it is also the case that some industries and businesses have a greater need for credit. Survey data indicate that some SMEs perceive a lack of access to additional funds as a barrier to general business activities and innovation — but these SMEs may not have been creditworthy or may have wanted finance on different terms.

Irrespective of the extent to which inefficient credit constraints exist, the major role that collateral plays in obtaining finance suggests that more diversity in the loans available to SMEs (such as lending using different types of collateral or no collateral) would open up new borrowing opportunities. The next chapter considers this issue.

3. The emergence of new lenders and products

Key points

- * **While Australian banks remain the major source of funding for small and medium enterprises (SMEs), they have broadly shifted away from SME lending. Compared with mortgage lending, lending to SMEs can be relatively costly because of higher (regulated) capital requirements, more complex credit assessments and the higher risk of default. This shift has created opportunities for non-bank SME lenders, with few regulatory barriers to new lenders entering or existing lenders growing.**
- * **Innovative use of new technologies and data sources has enabled lenders to assess more accurately the creditworthiness of prospective SME borrowers.**
 - Some lenders are accessing SMEs' financial data via accounting software and screen scraping and using artificial intelligence and machine learning to analyse large volumes of customer information.
 - Government policies to promote data sharing, such as comprehensive credit reporting and the Consumer Data Right, are also useful.
- * **With new and existing lenders expanding their SME offerings, there are a diverse range of providers of debt finance to SMEs. These lenders have different risk appetites and approaches to lending compared with banks.**
 - Fintech lenders are generally willing to serve less asset rich SMEs that may struggle to obtain finance from banks. Their data-driven processes can enable them to offer smaller loans with shorter terms, quickly.
 - Some lenders, such as private credit providers, tailor loans for SMEs either by using a mix of assets as collateral or lending unsecured. These bespoke products are usually limited to larger loans because of high transaction costs.
- * **More lending options, beyond traditional property-secured loans, have become available to SMEs. Some are new products; others are established products being offered more widely.**
 - SMEs can borrow against alternative collateral, such as vehicles, machinery and intangible assets (for example, invoices and other expected receipts).
 - Unsecured lending is an option for profitable SMEs with few or no assets, although it can be costly. There appears to be a gap in the market for unsecured loans between \$250 000 and \$5 million. This gap is not due to regulatory barriers, and instead likely stems from commercial realities facing both lenders and SME borrowers.
- * **These changes have benefited SMEs seeking access to finance. New lending options have enabled some SMEs to borrow more quickly, and others to obtain finance where they may previously have been unable to do so (for example, because they lacked property collateral).**

3.1 Regulatory and technological changes have opened new opportunities

Banks have shifted away from SME lending, partly due to regulation

As highlighted in chapter 2, Australian banks' business lending as a share of their total lending has been declining since 1990. Two factors have particularly contributed to a shift away from lending to small and medium enterprises (SMEs): the higher capital requirements for SME loans and the relatively more difficult process of assessing the creditworthiness of SME borrowers, compared with residential property loans. The Commission's 2018 inquiry on *Competition in the Australian Financial System* noted that:

SME lending (debt finance provided through term loans, overdrafts, lines of credit and business credit cards) is not as profitable for [authorised deposit-taking institutions] compared to lending for residential property or personal lending. This has resulted in more capital being allocated to lending in those areas with higher returns. (PC 2018, p. 445)

In Australia, authorised deposit-taking institutions (ADIs) must meet capital adequacy regulations that are generally above the minimum standards recommended by the international Basel guidelines, and are required to hold more capital against SME loans (not secured with property) than personal home loans. These requirements were designed to ensure that prudentially regulated institutions in Australia are 'unquestionably strong', with the intent of promoting financial stability and protecting depositors (as well as the Australian Government, given its deposit guarantee of up to \$250 000 if an ADI fails) (APRA 2020b; PC 2018, pp. 93–94).

These prudential regulations have contributed to banks' shifting away from SME lending in the past, and preferring less-risky loans when they do offer SME finance, such as requiring property as collateral (PC 2018, pp. 442–443). Some stakeholders have observed that this shift has been associated with a decline in banks' business banking skills, such as their ability to make judgement-based decisions and structure appropriate finance solutions for small businesses (Kavanagh 2011). This, in turn, can make it more difficult for banks to assess SME loan applications and further facilitate their shift towards home loans.

There are positive signs for the SME lending market, however. While SME lending in Australia is still largely comprised of finance issued by banks (figure 2.2), the banks' general shift away from these loans has led to the entry of new lenders in the market (section 3.2).

Proposed changes to Australia's capital adequacy framework — which are expected to be implemented from January 2023 — could support banks' SME lending activity in the future (APRA 2021a). These include lower capital requirements for SME loans not secured by property and allowing smaller ADIs to adhere to a simpler regulatory capital framework (APRA 2020a, p. 8).

Data and technology improvements enable lenders to offer new products

New SME lending opportunities are also being created through the innovative use of new technologies and data sources to enhance risk assessment processes and lower the costs of SME credit decisions. For example, some lenders are now applying artificial intelligence and machine learning to large volumes of customer information — such as banking, accounting, credit bureau and tax data — as part of undertaking risk assessments. Historical data from past loan applicants can also be used to refine credit assessment

models and improve prediction accuracies for future lending (Microsoft 2019; Prospa 2019b, pp. 61–63). According to the World Bank's report on *Alternative Data Transforming SME Finance*:

[Lenders] are now able to develop a more comprehensive view of the borrower's business — one that illuminates previously invisible SME strengths and weaknesses.

The basis for this amplified view is a real-time flow of the SME's digital footprint from the borrower to the lender that creates and continuously updates a rich model of the business. ... The more diverse the data and the faster the data can be analyzed, the more predictive its value will be. (World Bank 2017, p. viii)

These data can be gathered through application programming interfaces, which allow lenders to extract information directly from various sources (such as accounting software) with permission from the SME borrower. Data can also be obtained through 'screen scraping', whereby SMEs provide their online banking credentials to a prospective lender, who then accesses their banking portal to download, format and analyse data on previous transactions (FinTech Australia 2017, p. 7).

The increased visibility over a borrower's business activities and financial position garnered from these data has enabled lenders to build a more accurate picture of the creditworthiness of a potential SME customer.¹⁵ As a result, lenders are better able to distinguish between more and less creditworthy firms. More creditworthy SMEs may be able to access finance that was not available before, or on better terms.

Many SME lenders are accessing data from potential borrowers to use for credit decisions on their own initiative. These efforts have been supported by government policy changes that aim to facilitate more business lending by promoting data sharing and addressing information gaps.

- Comprehensive credit reporting was introduced in Australia in 2014. This increased the supply of consumer credit information to credit bureaus by supporting the sharing of 'positive' information, such as repayment history, in addition to 'negative' information, such as overdue payments and defaults. Although this reporting is limited to consumer credit information, business lenders also use these data to make credit decisions (Connolly and Bank 2018). Participation by the major banks was made mandatory from July 2021 (Treasury 2019b). Lenders reported to the Commission that the quality of this information has improved over time as more credit data are cumulatively reported, and it will further improve.
- The Consumer Data Right (CDR) is being phased in for ADIs, with data sharing rules initially released in August 2019. Also known as 'open banking', the application of the CDR to this sector provides borrowers with better access to their own banking data, which they may share with third parties — for example, other lenders or product comparison sites. ADIs are also required to disclose more product information under this regime. Data for most business finance products are among the last to be shared in the phased CDR rollout, but the existing timeline requires all banks to provide account and transaction data on these products by February 2022 (ABA nd; Treasury 2019c, 2019d).

¹⁵ However, some stakeholders have expressed concerns that credit decisions made using these analytical models may not be explainable to customers and regulators if challenged, or that credit assessments may be biased if algorithms are based on historical data that capture discrimination based on particular borrower characteristics (FSB 2017).

3.2 Few barriers exist, enabling lenders to enter and grow

The regulatory environment supports new SME lending

Growth opportunities in the SME lending market can only be fully realised if unnecessary regulatory barriers to lenders' entry and expansion are minimised. Overall, the existing regulatory environment is conducive to competition and supports new entrants and products in the SME lending market.

The Commission has heard from both regulators and lenders that non-bank business lending is lightly regulated in Australia. For example, lenders that are not ADIs (most of the newer lenders in the SME market) face little macroprudential regulation. The capital adequacy regulations discussed in section 3.1 do not apply to these lenders, as they do not take deposits from the public and, based on their size and relatively targeted lending activities, there would be limited harm to Australia's financial stability in the event of their bankruptcy.

Lending to business customers is also lightly regulated compared with lending to consumers. In Australia, the *National Consumer Credit Protection Act 2009* (Cth) stipulates that consumer lenders must obtain an Australian credit licence and adhere to responsible lending obligations, involving disclosure obligations and assessment that a credit contract is 'not unsuitable' for the consumer (ASIC 2014a, 2021). Lending to businesses is considerably less regulated to avoid imposing onerous barriers to finance and impeding access to liquidity, which may come at a significant cost — for example, the loss of a time-sensitive business opportunity (Australian Government 2018, pp. 159–184; Treasury 2020b, p. 35).

That is not to say that business lenders in Australia face zero regulations — lenders must comply with the *Corporations Act 2001* (Cth), anti-money laundering laws and privacy laws, among other requirements. Licences are required for particular activities; for example, an ADI licence is required to operate as a bank and an Australian financial services licence is required to conduct some services (such as operating a managed investment scheme) (APRA nd; ASIC 2014b).

Lenders seeking to become an ADI may first obtain a restricted ADI licence, which allows a limited range of banking activities for two years before a full licence is needed (APRA 2018). This staged approach seeks to strike an appropriate balance between financial stability and customer protection (which may benefit from stronger regulation), and supporting competition and innovation in the financial system (which may be limited by regulation). The restricted licence has been used by some new consumer lenders, and the digital business bank Avenue Bank — which intends on offering short-term working capital finance to SMEs — was granted a restricted licence in September 2021 (APRA 2021b; Evers 2021).

Although lending to businesses is relatively lightly regulated, SME lenders sometimes feel that they must follow the responsible lending obligations required under consumer lending regulations. This is because the personal and business finances of SME borrowers are often intertwined, making it difficult for the lender to determine whether a loan is predominantly for business or consumer purposes, and therefore what regulations apply. However, amendments to the National Consumer Credit Protection Act have been introduced to exempt lending that is partly for small business purposes from responsible lending obligations (Treasury 2020a).

New and existing lenders are providing SMEs with better access to finance

The limited barriers to entry and operation have enabled new lenders to enter the SME lending market and existing credit providers to expand their product offerings over recent years, particularly as opportunities have arisen from traditional banks shifting away from SME lending. There are now a diverse range of lenders providing debt finance to SMEs in Australia, many of which are not banks (box 3.1). While banks have

traditionally preferred to undertake lower-risk SME lending by requiring property as collateral (chapter 2), other lenders have different risk appetites, offer different value propositions and serve separate market segments to the banks.

Box 3.1 – Lending providers in the SME market

There are different types of lenders from which small and medium enterprises (SMEs) can access credit. Within these provider types, a lender may specialise in serving a particular sector or providing a certain type of finance.

Banks are financial institutions that offer a wide variety of finance products, typically at a cheaper cost than other lenders. They use a range of funding sources, including by accepting deposits from the public (which requires an authorised deposit-taking institution (ADI) licence) and by issuing bonds to wholesale markets. This study uses the term ‘bank’ to describe those with a physical presence, such as through a branch network.

Neobanks (also known as challenger banks or digital banks) are banks with no physical branches, usually operating via a website and mobile application. In-person interactions may take place as part of a business credit application. Neobanks have ADI licences but typically offer fewer products than banks.

Fintech lenders describe lenders that rely on technology in making credit decisions. Though many lenders use technology for processing loans, fintechs are differentiated by an online application process and fast, automated decisions and funds transfers. They have no physical presence and most have limited product offerings.

Finance companies provide lending but are not authorised to take deposits. Some finance companies provide a broad range of products, while others specialise in lending to particular sectors or for specific purposes, such as equipment finance for farming, mining, hospitality or health care. Many have a limited physical presence (but some do have offices).

Private credit refers to lending carried out by private funds. Funding is sourced from institutional investors or wealthy individuals, and they can provide debt directly to a borrower (typically in larger amounts than other lenders) or buy debt securities issued by other lenders.

Several other lending providers also offer SME debt finance, including peer lenders (where SME borrowers can use online marketplaces to be directly matched with individual investors) and e-commerce and payments companies.

Fintech lenders are willing to offer less asset-rich SMEs smaller, shorter-term loans

The riskier end of the SME market is predominantly served by non-bank lenders; for example, fintech lenders are more likely to offer loans that are not secured with collateral (unsecured lending products are discussed in further detail in section 3.3). Loan default rates reported by a fintech lender range from 4–6 per cent (Fowler 2019), which is higher than the approximately 2.5 per cent default rate on small business loans estimated by the major banks (figure 2.8).

Fintech lenders have emerged as an alternative to banks for SME borrowers seeking relatively small and short-term loans. The Reserve Bank of Australia has observed that ‘Australian small businesses have increased their use of non-traditional finance sources over recent years’ (Black, Lane and Nunn 2021, p. 16).

Business lending by fintechs in Australia, to SMEs and larger firms combined, has increased rapidly from about US\$10 million in 2013 to US\$487 million in 2020 (Ziegler et al. 2018, p. 87, 2021, p. 102) — although fintech lenders' activity is still very small compared to the overall SME lending market (\$423 billion of outstanding lending as at April 2021; figure 2.2). Some of the early entrants to the Australian market included Capify, Prospa and Moula, which commenced operations in 2008, 2011 and 2013, respectively (Moula nd; Prospa nd; Thompson, Macdonald and Boyd 2020).

Fintech lenders have filled a niche in the SME lending market, serving borrowers who may experience difficulties accessing finance from banks. Some of these lenders are willing to offer small loans to less asset-rich borrowers. In addition, the data-oriented approach to SME lending, discussed above, has been widely adopted by fintech lenders and has been used to identify relatively more creditworthy borrowers among those with limited collateral.

Innovative use of new data and technology is a significant factor enabling the growth of fintech lenders in the Australian market. While there are fixed costs associated with a lender developing its analytics capabilities and accessing suitable data, the approach is relatively scalable across a large volume of SME loans as the transaction costs per additional loan can be relatively low (Microsoft 2019; Prospa 2019b, p. 63, 80-81). Low transaction costs also enable lenders to offer smaller loans with shorter terms, and the relatively automated credit processes generally mean a quicker turnaround time from SME loan application to approval. As such, fintech lenders have also differentiated themselves from existing market participants by offering faster credit assessments (ASBFEO 2018, pp. 21–22).

Other providers issuing larger loans use a bespoke approach to risk assessment

Larger loans typically require a more bespoke approach to risk assessment than the higher volume, data-oriented method. Undertaking an individualised credit assessment process can have benefits for both the lender — in more accurately assessing and mitigating risks — and the borrower, who may receive better lending terms.

Building a detailed understanding of a SME customer through a bespoke relationship and information gathering process enables the lender to structure a tailored security arrangement. This allows the SME to use a mix of assets as collateral, depending on what they have available, or to borrow on an unsecured basis against future cash flows as required (Bou Hamze and Van Wyk-Allan 2021, p. 4). Some lenders may also have bespoke knowledge about the value and risks of a SME's assets, which enables more specialised lending arrangements.

For example, private credit providers individually structure debt deals based on a borrower's needs and fundamentals, which informs their decisions on loan terms, interest rates and covenants. Credit from these providers can be particularly suitable for SMEs looking for equity finance in addition to debt, as deals can be structured with a private equity component. The pre-loan risk assessment process generally involves undertaking detailed screening and due diligence on a prospective SME borrower to examine company performance, current and future cash flows, market conditions, management quality, security quality and exit strategies if conditions deteriorate.

Private credit providers can be highly selective in the debt that they issue — for example, the Moelis Australia Private Credit Fund previously reported that it only executes 5 per cent of total lending opportunities presented (IIR 2020, p. 10). After issuing a loan, the lender may actively monitor it and assist the borrower in implementing operational improvements if it shows signs of deterioration. The transaction costs associated with these processes are relatively large, and so private credit providers generally only offer loans above a certain size to ensure these costs can be covered.

Other SME lenders also undertake bespoke risk assessments to varying depths and for varying loan sizes. For instance, the neobank Judo Bank promotes a relationship-based lending model, engaging with SME customers to understand their borrowing needs and determine what type and size of loan can be offered, its terms and the collateral required (Eggleton 2021; Judo 2020, p. 10).

The more individualised approach to lending requires the lender to employ skilled bankers who can uncover and assess relevant business information for credit decisions (Judo 2020, p. 10). Additional scale requires recruiting more skilled bankers, which is likely to involve higher marginal costs and may also be limited by the size of the talent pool for these skills.

Banks are also interested in using technology to capture SME growth opportunities

Although banks have generally shifted their focus away from SME lending (discussed above), they are also reportedly ‘seeking more opportunities to lend to businesses, including smaller businesses’ (RBA 2021c), despite the constraints of existing prudential regulations (section 3.1).

Several banks have invested in technology to improve their business loan assessment processes, both by building in-house analytics capabilities and partnering with technology companies. For example, the Commonwealth Bank of Australia announced in June 2021 that it will be using technology from Waddle, a fintech lender, to better understand SME customers’ working capital needs and assess creditworthiness (CBA 2021b; Thomson 2021). Since 2020, National Australia Bank has partnered with Rich Data, an artificial intelligence company, to use data to improve its credit decisions for small business loans (Eyers 2020).

Some banks are also building up their SME offerings by employing more small business bankers (NAB nd; Yeates 2019). And, while banks have traditionally required collateral for SME loans, each of the major banks has launched an unsecured business lending product in recent years (ANZ 2021; CBA 2020c; NAB nd; Westpac nd). However, the Commission has heard in consultations for this study that banks’ tolerance for riskier unsecured lending remains limited compared with fintech lenders.

Non-bank lenders fund their SME lending using different sources

Access to funding influences lenders’ scale and product offerings. ADIs fund much of their lending activity through deposits, which represent about 60 per cent of their overall funding and are relatively low cost and ‘sticky’ due to low variation in account balances over time (RBA 2021a; Schroders 2019, p. 13). In contrast, non-bank lenders are unable to take deposits from the public. While this means they benefit from not having to meet capital adequacy regulations (section 3.1), they must also obtain funding from alternative sources that may be less available or more costly. However, innovations in capital markets and a large global pool of funds seeking higher returns have facilitated access to funding for lenders.

Lenders can source funding from private and public capital markets.

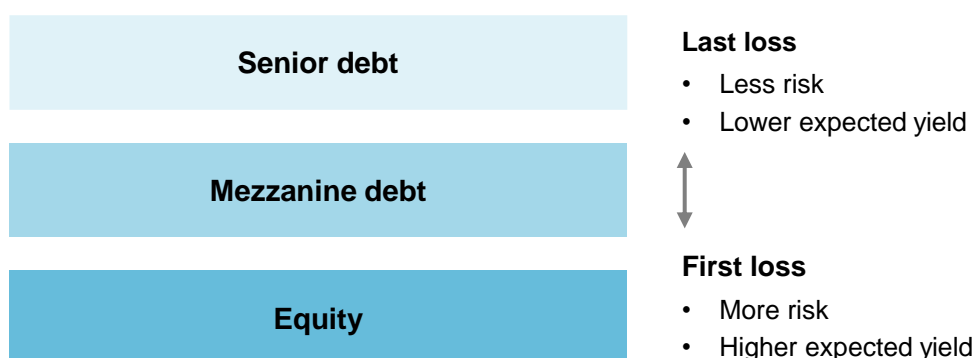
- Private credit funds largely source their capital directly from wholesale investors, which include institutional investors and high net worth individuals. And private equity funding is particularly important for very small non-bank lenders, as their lack of scale limits their ability to access other funding sources (Causeway nd; IIR 2020; Neu Capital nd).
- Larger lenders with more established operations can raise funding through public listings, which enables them to source capital from both retail and wholesale investors. For instance, the fintech lender Prospa was listed on the Australian Securities Exchange (ASX) in 2019, and private credit funds with sufficient scale can also list funds on the ASX (such as the Metrics Master Income Trust, listed by private credit provider Metrics Credit Partners in 2017) (Metrics nd; Prospa 2019a).

Another funding option used by SME lenders is securitisation, whereby the SME loans they originate are packaged into securities and can then be sold to other investors. These securities are said to be ‘backed’ by the original SME loans — that is, the cash flows from SME borrowers making loan repayments are used for principal and interest payments to investors in the securities. The ability to sell these securities depends on various factors such as market liquidity, the reputation of the lender and investors’ confidence in the underlying loans.

SME lenders seeking funding via securitisation generally initially use ‘warehouses’ as finance facilities. Warehouses are used to build sufficient loan volumes and performance history, which is typically required to issue securities to the market. While warehouses are temporary finance facilities that typically operate for relatively short terms (for example, one year), they may be renewed to provide a revolving source of capital for lenders (PC 2018, p. 226; Pepper 2014, p. 1). Warehouses are structured with tranches of varying degrees of subordination — that is, protection from losses — and typically include (figure 3.1):

- a senior lender that is relatively protected against credit risk (which could be a large commercial or investment bank)
- subordinated mezzanine investors (which could be private credit funds or other non-banks)
- the SME loan originator holding about 10–30 per cent equity in the facility so that they bear the first risk of any losses. While this equity contribution helps to incentivise the origination of high-quality loans, a warehouse with a high equity requirement can limit the growth potential of SME lenders, as this capital could otherwise be used to back other facilities (or for another growth purpose such as hiring staff) (Neu Capital nd; Treasury 2019a, p. 19).

Figure 3.1 – Typical warehouse structure



Source: Neu Capital (nd); Treasury (2019a, p. 18).

Securitising a large number of small SME loans provides greater granularity in the underlying pool of assets that back the security, which improves diversification and can therefore be more attractive to investors (Jobst 2008). But Australia’s market for SME loan-backed securities is relatively small and underdeveloped compared with other asset-backed securities markets, such as residential mortgage-backed securities.¹⁶

Between 2016 to 2018, about \$4 billion of deals backed by secured SME loans and \$130 million of deals backed by unsecured SME loans were issued — with the latter consisting of a handful of small private deals, often with a single investor (Treasury 2019a, p. 19). Since April 2020, most publicly marketed deals of securitised business loans issued by non-ADIs have been backed by secured loans. Deals backed by secured loans to SMEs were primarily residential and commercial mortgages, while deals backed by secured loans to businesses more generally (which likely included SMEs and larger firms) had a more diverse range of collateral, including vehicles and agricultural and construction equipment (pers. comm., RBA, 23 July 2021). Although there has been limited securitisation activity for

¹⁶ The total amount of residential mortgage-backed securities outstanding in Australia was \$118 billion as at March 2021, which represented about 80 per cent of total securitisation activity (ABS 2021). Residential mortgage-backed security deals are generally large, publicly marketed and have a number of investors across several tranches that are often rated by credit rating agencies (Arsov, Kim and Stacey 2015, pp. 46–49). These securities are usually able to be bought and sold in a secondary market (Treasury 2019a, p. 19).

unsecured lending, in September 2021 the fintech lender Prospa — a large provider of unsecured SME loans — issued a \$200 million public deal backed by loans and lines of credit to SMEs (KangaNews 2021). The different types of secured and unsecured loans available to SMEs are discussed further in section 3.3.

The tranche structure of SME loan-backed securities allows investors with varying risk and return preferences to provide funding to non-bank lenders that originate SME loans and gain exposure to growing market segments. These investors include banks, which may not issue large volumes of riskier loans themselves due to lower risk appetites, but can instead invest in the senior tranche of a SME loan-backed security.

3.3 SMEs have a diverse range of lending options available

The evolution of Australia's SME lending market over recent years has meant that a diverse range of lending products are available to SMEs, beyond the traditional property-secured options discussed in chapter 2. Some products are relatively new offerings while others may have been offered for some time but are becoming more widely available as new lenders enter and existing lenders grow in the SME market. These developments have benefited SMEs seeking access to finance, as improving their ability to choose between more lending options reduces their likelihood of facing credit constraints.

Table 3.1 summarises the types of debt products available to SMEs. In general, lending backed by higher-quality collateral is available for larger amounts, at longer terms and at lower interest rates, but this can vary across different lenders and security. Besides collateral, other factors that lenders use to assess a borrower's risk include their financial statements, trading history, business plan and purpose for seeking finance.

Table 3.1 – Lending products available to SMEs seeking finance
By type of security, September 2021

| Security | Typical loan sizes | Typical loan terms | Typical interest rates |
|--|---|---|---|
| Residential property | From \$10 000, representing up to 80 per cent loan-to-value ratio (LVR) | 1–30 years | Slightly less than 4 per cent |
| Commercial property | From \$10 000, representing up to 70 per cent LVR | 1–25 years | Additional 0.3–2 per cent margin relative to residential property, to reflect higher risk |
| Physical business assets | From \$5000, depending on equipment value | 1–7 years, cannot exceed asset's useful life | From 3 per cent, depending on equipment and creditworthiness |
| Other business assets^a | No or very high maximums, offered as an increasing line of credit as receivables grow, up to 95 per cent of their value | Generally short-term, such as 30–90 days per advance as part of a one-year contract | From 5 per cent, depending on the product and creditworthiness |
| Unsecured^b | \$5000–\$250 000, based on creditworthiness From \$5 000 000, based on cash flow | 3–36 months Highly dependent on the borrower and deal | 15–35 per cent Highly dependent on the borrower and deal |

a. Other business assets are predominantly invoices, but can also include other expected receipts such as future tax credits and non-receivables such as patents. **b.** Unsecured loans to SMEs are typically covered by a personal guarantee or general security agreement with a business owner or director.

Source: based on Commission consultations and a desktop scan of publicly available information as at September 2021. Sources include Bank of Sydney (nd); CBA (2020a, 2020b); Earlypay (nd); FundingPro (2020); ING (2019); Moula (2021); Pepper Money (nd); Prospa (2021); RBA (2021b); Scottish Pacific (2021); Suncorp (2021); Westpac (nd, nd).

Various business assets can be used as security

Besides property, SMEs can pledge other physical assets — such as vehicles, machinery and equipment — to access finance. This can be in the form of finance to buy a new piece of equipment (known as asset finance) or loans where existing equipment is used as collateral. Under the latter, similar principles to property-secured lending apply: lenders provide credit depending on the estimated value of the asset, up to a particular loan-to-value ratio based on their risk appetite, and are entitled to repossess the asset if the borrower defaults. The loan approval process typically requires an asset valuation and additional documentation, such as proof of equipment maintenance.

Asset finance may be used when a SME requires debt to purchase or lease a new physical asset and uses the asset being funded as security. Various types of asset finance are available (box 3.2). The terms of asset finance largely depend on characteristics such as the asset's value and expected useful life. Much like other types of collateral, lenders prefer assets that can be easily liquidated, such as assets purchased from a store (rather than a private seller), produced by a reputable company, new (rather than used) and in common use (rather than of a specialised nature).

Box 3.2 – Types of asset finance

Asset finance can be used by small and medium enterprises (SMEs) to buy or rent equipment or other physical assets for business purposes. There are several types of asset finance.

- A **chattel mortgage or equipment loan** is used by the borrower to purchase and own an asset outright. The lender issues a goods mortgage over the asset as security and the asset can be repossessed in the event of a default. The loan requires periodic repayments with a residual amount ('balloon payment') due at the end of its term.
- Under a **commercial hire purchase**, the lender purchases an asset and hires it out to the borrower for a period of time. The lender owns the asset until the borrower repays the total loan amount. Asset ownership is then transferred to the borrower.
- Assets can be leased through an **operating or finance lease**. This arrangement is similar to a commercial hire purchase agreement, except the SME borrower does not agree in advance to take ownership of the asset at the end of the lease's term.
 - An operating lease is relatively short term, with the SME typically returning the asset at the end of the lease. This type of lease enables a business to upgrade its assets more quickly.
 - A finance lease is longer term and allows the SME to buy the asset at the end of the lease at an agreed price (typically the residual amount).

Businesses choose the type of asset finance they apply for based on the asset's lifespan, features and use. The different accounting treatments and tax benefits available for each type of finance can also influence their decision.

Source: Gordon (2018).

The Australian Financial Industry Association estimated that new business asset finance in 2019-20 (to SMEs and larger firms combined) was \$45.6 billion; this was mostly comprised of chattel mortgages (Tate 2021, p. 117). Despite the prevalence of chattel mortgages, the OECD's report on *New Approaches to*

SME and Entrepreneurship Financing stated that leasing can be a more flexible approach for SMEs to fund their use of capital assets:

Leasing can be especially advantageous for firms that anticipate changing their capital assets frequently, as it allows accessing equipment with minimal initial costs and moving rapidly to more up-to-date assets without incurring further capital outlays. (OECD 2015, p. 30)

Asset finance is provided to SMEs by a range of lenders, including banks, but the market is relatively more competitive than property-secured SME lending. Banks are generally more willing to offer asset finance for less risky loans — for instance, the Commission has heard in consultations that banks are more likely to fund purchases of equipment that has a highly liquid secondary market. Other lenders such as finance companies are typically more willing to fund specialised equipment that is harder to resell and may develop specialised capabilities and processes to improve risk assessments for these loans. Equipment vendors can also offer credit, such as car finance, to support their sales.

Other assets on a SME's balance sheet that are not physically tangible can also be used as loan security. The most notable example is debtor finance — also known as invoice finance or accounts receivables finance as it uses outstanding invoices as collateral. Under a debtor finance agreement, the SME borrower receives credit based on the value of its future invoices.¹⁷ The arrangement may be on a once-off, casual or contractual basis, and can include some or all of their accounts receivables ledger. Debtor finance can be provided as a loan or a fluctuating line of credit that increases as the borrower's receivables ledger grows and decreases as invoices are paid.

These products enable SMEs to receive payment upfront from a lender, rather than waiting for the invoice recipient to pay — payment terms for small business suppliers generally range from 30 to 90 days, with one survey having reported an average of 56 days (Scottish Pacific 2020, p. 20). The amount of funds advanced can be as high as 95 per cent of the outstanding invoices used to secure the debt (Scottish Pacific 2021), with the balance (less interest and other fees charged by the lender) returned to the SME when the invoice recipient makes full payment.

Loans secured by equipment and invoices have been available to SMEs for some time; however, several market participants have suggested that these lending products are driving broader growth in SME lending. For example, in recent years some banks have returned to providing debtor finance products following their withdrawal after the global financial crisis in the late 2000s (Frost 2021a; Jones 2015). The size of the Australian debtor finance market (for SMEs and larger firms combined) was estimated to have grown from about \$36 billion in 2005 to \$64 billion in 2015, in terms of the total face value of invoices that were purchased by lenders over the year (Ashurst 2016).¹⁸ And various lenders have reported significant increases in asset finance to SME customers, with expectations of future growth (CBA 2021a; Frost 2021b).

Apart from debtor finance, SMEs can also access credit using other types of expected receipts as security. One example of this is research and development (R&D) finance, which enables SMEs eligible to receive R&D tax offsets to access upfront capital secured by the future receipt of their tax refund. This relatively short-term finance enables businesses to receive funds and invest in R&D activities immediately, rather than having to wait until the

¹⁷ There are two forms of debtor finance. Invoice discounting is borrowing that is secured against a SME's outstanding invoices, while invoice factoring involves the SME selling its invoices to a lender who then becomes responsible for collecting payment. Since invoice factoring requires more work from the lender, it is usually more expensive than invoice discounting.

¹⁸ The amount of funds actually lent to businesses under these arrangements would have been lower, as only a portion of the face value of outstanding invoices is provided to the borrower as credit.

end of the financial year. The loan or line of credit is repaid with interest once the SME receives its R&D tax refund, which can be up to 43.5 per cent of their expenditure on R&D activities (ATO 2017).

Unsecured lending is another option

As discussed in section 3.2, a range of lenders — including newer fintech lenders and, in some recent cases, banks — provide SMEs with access to finance that does not require collateral. These unsecured options often require the SME owners or directors to provide the lender with a guarantee or security agreement (box 3.3).

Box 3.3 – How can lenders get security without collateral?

Security agreements and guarantees are contracts that outline the borrower's legal obligations and the lender's rights in the event of a default. These can be used as an alternative to the borrower pledging business assets as collateral for a loan.

A **personal or director's guarantee** outlines the conditions under which a guarantor — usually the business owner or director — becomes responsible for the business's debt obligations. They are personally liable for their business's debt and can have their personal assets seized in the event of a default. Guarantors are not released from their obligations unless the loan has been repaid or there is consent from both parties to do so.

A **security agreement** gives the lender a legal claim over the borrower's assets, via a security interest. A general security agreement (GSA) covers all of the borrower's present and future assets, while a specific security agreement (SSA) covers a particular asset, such as equipment, licences or intellectual property. Security interests covered by these agreements can be registered on the Personal Property Securities Register, a national public noticeboard of security interests over assets (besides property) that legally assigns the priority of these interests under a 'first in, best dressed' principle.

Guarantees and security agreements are standard practice in lending to small and medium enterprises. However, entering a GSA with one lender can limit a borrower's ability to get finance from other lenders: since it covers all assets, a borrower may not be able to offer these assets as security to a second lender (unless an agreement is made to do so).

Source: AFSA (nd, nd); MFAA (2020).

There are two types of unsecured lending products available in the Australian SME market (table 3.1). At the smaller end, loans are issued using a relatively standardised assessment of the borrower's creditworthiness — often based on the technology and data-oriented approach discussed in section 3.2 — and are typically capped at \$250 000. Loan terms are also considerably shorter than most secured forms of finance.

Higher interest rates are charged to compensate lenders for the increased risk they bear. This premium can be significant — the Commission's market scan suggests that this type of short-term unsecured lending typically has interest rates that are 4–9 times higher than lending secured by residential property (table 3.1). While the interest rate is high, SMEs that urgently need finance to take advantage of an immediate business opportunity (for example, by purchasing supplies or hiring new staff) may earn more from borrowing and using these funds than the amount of interest paid. As an illustrative example, a SME looking to borrow

\$10 000 for one year at an interest rate of about 20 per cent would pay interest costs of about \$1000 to \$2000, depending on the loan repayment structure, which could be earned back in a profitable venture.¹⁹

At the larger end of the unsecured lending market, SMEs seeking debt finance of about \$5 million or more may be able to access finance via a deal tailored to their circumstances and borrowing needs, such as those offered by private credit providers (section 3.2). These are typically private bespoke arrangements, so it is impossible to generalise about their terms and cost. They appear to be mainly available to larger and more established SMEs.

The availability of unsecured products suggests that other aspects of financial performance affect a SME's ability to obtain debt finance, besides their asset ownership (as was highlighted in figure 2.6). This could include their profitability. Previous research on Australian businesses found that 'firms with high profitability relative to others in their industry had a higher probability of obtaining credit than less profitable firms' (Araujo and Hambur 2018, p. 7).

There is a gap in the available unsecured lending products

There appears to be a gap in the market for unsecured SME lending between the two thresholds described above, with few lending providers willing to offer unsecured loans in the \$250 000 to \$5 million range. In consultations for this study, the Commission heard that there are a very small number of unsecured private debt deals of this size, but they tend to have a narrow focus (such as high-growth technology SMEs) and it is generally challenging to access finance in this segment.

This gap would only represent a problem with market functioning if there are regulatory barriers preventing SME borrowers and willing lenders from reaching a deal, but as discussed in section 3.2, the Commission has not identified significant regulatory barriers inhibiting SME lending activity. A gap in the range of products offered could also be due to commercial realities consistent with an efficient market. For example, lenders will be cautious about lending large amounts without some form of security, and the due diligence required to manage the risks of this unsecured lending (where possible) may be too costly for mid-sized loans. In addition, SME borrowers may be unwilling or unable to pay a sufficiently high, risk-adjusted premium for entirely unsecured lending, instead preferring to access this amount of finance through other types of debt or equity. This gap could close as the Australia's SME lending market matures over time (chapter 4).

3.4 New lending options have significant benefits for SMEs

New lenders and products are of particular interest if they have a significant effect on the availability and accessibility of credit. For example, data-driven approaches to lending have enabled faster loan turnaround times — fintech lenders typically have an online application process with a quick decision and delivery of funds once the relevant data have been uploaded. Some reports indicate that the loan application process can take less than an hour and decisions can be made in under 24 hours, which represents an improvement on traditional loan turnaround times (ASBFEO 2018, pp. 21–22). Several banks are now offering similar application processes for smaller loans.

Borrowing more quickly has significant benefits for SMEs. Maintaining cash flows could allow a SME to avoid fees (for example, late payment surcharges) and reputational costs (for example, if staff were paid late).

¹⁹ The amount of interest paid depends on loan features such as the frequency of principal and interest repayments (which may be weekly, fortnightly or monthly) and how interest is calculated on the remaining principal amount. Lenders may also charge other fees, such as loan origination fees.

Rapid access to funds could also mean that a SME does not miss out on an important business opportunity; for example, bidding for a contract for which the business will need to source additional funds to supply according to contractual requirements.

Drawing on extensive banking or accounting data also provides lenders with richer and more reliable information about potential borrowers. Lenders can use this information to better distinguish more and less creditworthy SMEs, which might otherwise have looked identical in the absence of these data. As a result, more creditworthy businesses may be able to access finance at lower cost or on better terms, which could improve their profitability and growth. Borrowing may now be possible for some creditworthy SMEs that were previously rejected because they could not be differentiated from riskier businesses.

Many of the newer lending products available to SMEs do not require collateral (at least for some loan sizes and borrowers) or accept alternative forms of collateral that are not property (table 3.1). Some SMEs that were unable to access finance may now be able to borrow — for example, SME owners who are not homeowners can obtain a loan collateralised with a mix of invoices and other business assets. Young entrepreneurs seeking to grow their business could particularly benefit from this, given declining home ownership rates among young Australians (Wood and Griffiths 2019, p. 17). In addition, borrowing without property collateral may allow some SMEs to take entrepreneurial risks and make bigger investments to expand and innovate.

However, more lending options can lead to some SMEs taking on imprudent levels of debt and excessive risks. Several new products also charge very high interest rates, which may not be wise to accept in some circumstances. SMEs will need to make careful judgements as to whether the credit opportunity is worth its cost and the risk. While some businesses may make imprudent decisions (just as some people do with credit cards), if most SMEs successfully take advantage of these credit opportunities to fund and grow their business, it is likely a sign that new lending options are creating significant value for the SMEs in question.

4. Future market opportunities and implications

Key points

- * Further improvements to lenders' technology and data capabilities, and government efforts to promote information sharing, will continue to facilitate better access to finance for small and medium enterprises (SMEs).
- * The funding market for non-bank SME lenders is relatively small and underdeveloped, which could limit the future growth of these lenders. Government initiatives are supporting market development through targeted investments and promoting standardised reporting.
- * While most SMEs are aware of banks as a source of finance, awareness of other options is more limited. SMEs may mistakenly expect difficulties accessing finance if they do not know the full range of products and lenders available to them.
 - Brokers play an important role in educating SME borrowers and connecting them with suitable lenders and products. Through their participation in ongoing training, brokers are more likely to have up-to-date market knowledge about available lenders and products.
 - Building customer trust in alternative lending options could improve SMEs' uptake of these products. However, the industry's efforts to build confidence (including voluntary self-regulation of online SME lending products) have had limited impact so far.
- * More visibility and data on business credit are required to better understand Australia's evolving SME lending market.

4.1 Improving data capabilities and funding will enable further growth

Significant improvements to lenders' technology and data capabilities, and government initiatives to promote information sharing, have opened new opportunities for small and medium enterprise (SME) lending (section 3.1). These are relatively recent market developments — many SME lenders continue to invest in enhancements to their digital processes and explore new ways to use data on potential borrowers to assess credit risks. The scalability of this approach and increasing lender activity in the market suggests that improved technology and data capabilities will continue to facilitate better SME access to finance in the future.

Further development of funding markets for non-bank SME lenders will also enable future lending growth. Several factors contribute to the limited activity in Australia's market for SME loan-backed securities highlighted in section 3.2.

- It is difficult for investors and rating agencies to assess the underlying pool of SME loans backing these securities, as the available data are often limited and not standardised.
- Issuing a term securitisation deal is costly and newer SME lenders may not have the large loan book required to make the issuance costs worthwhile.
- The small market size can be self-perpetuating — SME lenders do not wish to issue a deal until they are certain that there will be sufficient investor interest, while investors do not want to examine a potential deal until they are relatively certain that it will proceed (Treasury 2019, pp. 19–21).

The funding market is expected to mature over time as SME loan volumes grow. The Australian Government is also supporting market development through the Australian Business Securitisation Fund (ABSF), which invests in warehouses and the securitisation market in 'underserved' SME lender segments (box 4.1). Through the ABSF's activities, the government is promoting more standardised reporting on the loans originated by SME lenders, with the aim of improving market participants' understanding of the securities that are created using these loans.

Box 4.1 – Government programs to develop the funding market

The Australian Government established the \$2 billion Australian Business Securitisation Fund (ABSF) in April 2019 to support the development of funding markets for small and non-bank lenders providing loans to small and medium enterprises (SMEs).

Administered by the Australian Office of Financial Management (AOFM), the ABSF co-invests in warehouses or term securitisation deals, with the amount of co-investment dependent on the needs of the issuer and investors. The AOFM is also supporting a transition to a common data standard, which will enable investors and credit agencies to better understand and assess the underlying SME loans. To achieve this, the Australian Securitisation Forum is developing a data reporting template (with input from various stakeholders), which includes information on the loans' characteristics, SME borrowers — such as credit history and sector of operation — and collateral used.

The ABSF focuses on the more 'underserved' segments of the SME market, both in secured and unsecured lending. Through this targeted activity, it aims to ameliorate the self-perpetuating lack of scale faced by many SME lenders, and assist these lenders in developing a track record to attract more private sector investment over time. Government activity in the funding market can then be pared back as the market matures.

When the ABSF was introduced, the AOFM had intended on investing small amounts in the SME market using these funds. However, the COVID-19 pandemic shifted these plans — the ABSF was paused, and a new \$15 billion Structured Finance Support Fund (SFSF) was set up to support the flow of credit to SMEs and consumers as part of the government's economic response. The ABSF has to date made a single \$250 million investment in a warehouse facility sponsored by Judo Bank (which also received a further \$250 million through the SFSF).

Source: AOFM (2019a, 2019b, 2020a, 2020b, 2021, nd, nd); ASF (2021b, 2021a); Treasury (2019).

There is insufficient information to determine how funding markets would have developed in the absence of the ABSF, although it appears to be a benign form of government intervention that could improve investor confidence at the margin. Reviews of the ABSF are scheduled to be undertaken two and five years after its commencement, which will include examining ‘the effectiveness of the ABSF in meeting its objectives’ (Treasury 2019, p. 14). The OECD has noted that through the ABSF, the Australian Government is ‘supporting the development of a clear track record for the [securitised SME loans] asset class and is also working with industry to help standardise data collection and reporting’ (OECD 2021, p. 99).

Similar programs have been implemented in other countries — governments in the European Union, United Kingdom, United States, Canada and Japan have used their balance sheets to support SME loan-backed securitisation markets, such as via credit enhancement or direct security purchases (Treasury 2019, pp. 22–23). For example, the European Investment Fund has provided credit enhancement to SME loan-backed securitisation transactions since the late 1990s, and a 2017 evaluation found that it had contributed to ‘market development not only through its transactional activities but also spreading know-how and best market practices’ (EIF 2017).

In consultations for this study, several lenders expressed to the Commission that they are open to offering more and larger loans in the future (including on an unsecured basis above \$250 000), facilitated by these ongoing developments in loan assessment practices and funding markets.

4.2 SMEs could be more aware of and confident in newer lending options

Promoting increased understanding of the full suite of lending options available to SMEs is another opportunity to improve access to finance. Greater awareness of newer lending options would assist in better matching SME demand for finance with the diverse range of debt products available. Given the historical dominance of banks in the Australian market (chapter 2), some other lenders have stated that ‘low awareness with SMEs [and a] lack of trust’ are significant challenges in lending to these customers (ASBFEO 2018, p. 38).

Limited awareness and lack of trust are two separate, but related, issues. SMEs may expect difficulties accessing finance if they do not know what products and lenders are available to them, even if they would actually be able to obtain debt through existing offerings in the market. A previous survey of SME owners found that ‘a quarter ... wouldn’t consider alternative lenders because they “don’t know who they are”’ (Scottish Pacific 2018, p. 11). Many SMEs are unlikely to have the time to investigate all available lending options, and given the variety of lenders offering finance, it can be difficult for SMEs to identify the most appropriate products and providers in the market.

For example, fintech lenders are relatively new market participants and can face challenges in making themselves known to SMEs. The industry association FinTech Australia has stated that ‘fintechs ... often encounter marketing difficulties as users generally do not accept their new concepts or products’ (FinTech Australia 2019, p. 7). In addition, some lending products are more complex than standard principal and interest loans, and so even established lenders may have difficulties communicating their product offerings to SMEs. For instance, invoice factoring (a type of debtor finance) has been confused with debt collection by some business customers (Niesche 2013).

Even if they are aware of the diverse range of lending options available in the market, SME borrowers need to have confidence in a particular lender and product before applying for finance. This includes trusting the information provided about loan costs and terms, which is sometimes inconsistent between lenders and not

displayed upfront to customers. For example, a 2018 survey conducted by the Australian Small Business and Family Enterprise Ombudsman found large variations in the pricing calculations and disclosure practices of fintech lenders, noting that ‘the actual fee structure may only become fully apparent when a borrower sees the Loan Agreement’ (ASBFEO 2018, p. 25).

Building customer confidence takes time. It may be especially difficult for lenders with newer business models and lending approaches. A previous study of businesses in the Asia-Pacific region found a general reluctance to use fintech services due to cyber security concerns (CPA Australia and Airwallex 2021, p. 4). The Australian Securities and Investments Commission highlighted that the fintech sector must develop robust cyber security practices to build customer trust (Armour 2019).

Brokers and other referral channels help to inform SME borrowers

Business finance and loan brokers are an important channel connecting SME borrowers and lenders. They can assist SMEs to broaden their awareness of available lending options, as well as build trust by conveying whether lenders are reputable.²⁰ SMEs approach brokers for their assistance in a range of financing needs, including purchasing or selling assets, accessing new finance and refinancing existing credit. One survey of SMEs reported that ‘four out of 10 ... use their brokers to source new finance’ (Scottish Pacific 2020, p. 27).

Australia’s broker market is relatively fragmented, with blurred boundaries between personal and business brokering, so there is no single estimate of market size. Previous research identified more than 11 000 commercial brokers operating in Australia in 2020 (CAFBA 2020, p. 2), though business lending can also be facilitated by other brokers. For example, another survey found that over 4500 mortgage brokers also wrote commercial loans in 2020, and reported that mortgage brokers are increasingly writing commercial loans as they seek to diversify their portfolios (MFAA 2020, p. 49). SMEs can also access business brokering services via online broker platforms, which predominantly connect borrowers to non-bank lenders.

Brokers help SMEs to understand the available lending options. By connecting borrowers to lenders, brokers can play an important education role, particularly for those SME customers that do not have the time or inclination to undertake detailed market research on their own. These SMEs may have difficulties in keeping up to date on lending market changes and emerging options, but brokers are expected to have current market knowledge and participate in ongoing training to stay informed about new lenders and products. For example, aggregators²¹ and industry associations hold various educational events — including conferences, workshops and webinars — to improve brokers’ understanding of SME lending options (Connective nd; FBAA nd).

Lenders also benefit from working with brokers in the SME market, as brokers are a convenient channel for business customer acquisition. Some lenders have reported that about 25–30 per cent of their new business lending originates through third parties such as commercial brokers (Mingas 2019; Mitchell 2017). It is likely that this share varies significantly across different providers based on their business models — for example,

²⁰ At the same time, the Commission has previously observed that customers can be reluctant to pay upfront for brokers’ services and that ‘the main way in which brokers are remunerated is through commissions, which are paid by lenders ... [and have] implications for the incentives that brokers face’ (PC 2018, pp. 319–320). This compensation structure could, for example, lead to conflicts of interest regarding the lenders and products that a broker recommends to a SME borrower.

²¹ Aggregators act as an intermediary between lenders and brokers, by providing a panel of lenders from which brokers recommend loans. Some aggregators do not allow brokers to recommend loans provided by lenders outside of their panel. Other services that can be provided by aggregators to brokers include risk management, compliance support, professional development and white-labelling services for loans.

in consultations undertaken by the Commission for this study, other SME lending market participants stated that at least half of their customers are sourced via brokers.

SME lenders also report mixed experiences with broker-referred customers. The Commission has heard conflicting views that brokers tend to refer more mature (and therefore lower-risk) business customers, that broker-referred customers have higher default rates and that there is no difference in the riskiness of customers based on their approach channel.

Apart from brokers, lenders can use other strategies to inform SMEs about their products and acquire business customers.

- Traditional marketing methods, such as direct mail and radio advertising, are used by some business lenders. This may be particularly useful for targeting particular SME market segments; for example, Prospa has bought airtime on the Triple M radio station to promote awareness to trades business customers (Cameron 2016).
- Lenders may partner with established brands, both to raise customer awareness and improve the lender's credibility. This can include lending providers offering direct access to their loans for business customers of large retailers, such as Moula's partnership with Officeworks (Moula 2016); or partnering with companies that have customer loyalty programs and using these as a referral channel, such as Valiant Finance's collaboration with Qantas's Business Rewards program (Eyers 2020).
- Some newer lenders have arrangements with banks whereby the bank refers loan applications that it rejects (for instance, because the application does not meet the bank's lending criteria) to the other lender, who — depending on their risk appetite — may be able to offer the customer an alternative. However, referrals made under these programs appear to be limited (Eyers 2018). Similar programs exist in the United Kingdom, where some banks are required to refer rejected SME customers to alternative finance platforms (HM Treasury and Glen 2016).

Industry's efforts to build confidence have had limited impact, so far

Lending to SMEs is relatively lightly regulated (section 3.2). Newer lenders without an established reputation in the Australian market may therefore have to work harder to gain the confidence of SME borrowers and assure potential customers that their lending practices are transparent and fair.

To develop greater trust in online SME lending products, the Australian Finance Industry Association released the *Online Small Business Lenders Code of Practice* in 2018, with the support of the Australian Small Business and Family Enterprise Ombudsman, the FinTech Australia industry association and the SME online resource theBankDoctor. The *Code* sets standards for lenders regarding disclosure on interest rates and other charges, timely and clear communication, and complaints resolution practices (AFIA 2020). One of its key mechanisms for improving transparency is the introduction of a standard pricing comparison document — including key metrics such as a loan's annual percentage rate (which some lenders do not advertise publicly) — to make it easier for SME borrowers to compare loans across participating lenders.

However, there can be limits on what this type of self-regulation achieves in improving customer confidence in online lending products and providers.

- The voluntary nature of the *Code*, which only has seven signatories so far, means that many lenders in the SME market do not comply (Eyers 2019). This is particularly the case for smaller providers, as most of the seven lenders with compliant online SME loan products are relatively large players in the non-bank market.
- Borrowers may not be aware of the *Code* and what it entails, or which products offered by the participating lenders are compliant. Even if SMEs can identify relevant lenders and products, it is not clear that the *Code*'s disclosure guidelines require sufficient information to be provided throughout the loan application process to enable the prospective borrower to make a fully informed decision.

As the *Code* was only recently introduced, some of these issues may improve in the future — for example, SME borrowers are likely to gain greater awareness of the *Code* and additional lenders could sign on with newly compliant products. More time is required to determine whether industry's efforts at building confidence have an effect.

4.3 More visibility is required for future research

Increased visibility over the SME lending market would enable a better understanding of the changing lending landscape. While business lending data collection has improved in recent years, some gaps remain. Compiling more detailed and comprehensive data on business lending — particularly by smaller lenders, as new entrants in the market tend to be — would allow researchers to undertake further analysis on recent and future market developments. This could include:

- more complete data on business lending that covers all credit providers in the SME market. For example, aggregate business lending data could be collected from lenders with less than \$2 billion in total business credit, as these are not captured by the Australian Prudential Regulation Authority's economic and financial statistics. This would ensure that data are available on newer SME lenders with smaller loan books, such as fintech lenders and private credit providers
- more detailed loan collateralisation data. For example, information on loan collateral could be consistently collected for different firm sizes (small, medium and large) and include more granularity on the security provided (such as commercial property, equipment, invoices or other assets). This would enable a better understanding of the different collateral options available to and used by SME borrowers.

Appendices

A. Conduct of research

Over the course of this study, the Commission held informal consultations and discussions with a range of regulatory bodies, industry groups, businesses and individuals from a variety of backgrounds (table A.1). The Commission is grateful for the input of these stakeholders provided throughout the study.

Table A.1 Consultations

| Participant |
|---|
| Alternative Credit Council (ACC) |
| Australian Banking Association (ABA) |
| Australian Finance Industry Association (AFIA) |
| Australian Office of Financial Management (AOFM) |
| Australian Prudential Regulation Authority (APRA) |
| Australian Securities Investments Commission (ASIC) |
| Australian Small Business and Family Enterprise Ombudsman (ASBFEO) |
| AustralianSuper |
| Australian Taxation Office (ATO) |
| Bishop & Fang |
| Business Information Industry Association (BIIA) |
| Commercial & Asset Finance Brokers Association of Australia (CAFBA) |
| Commonwealth Bank of Australia (CBA) |
| Council of Small Business Organisations Australia (COSBOA) |
| FinTech Australia |
| Finance Brokers Association of Australia (FBAA) |
| Judo Bank |
| Metrics Credit Partners |
| Mortgage & Finance Association of Australia (MFAA) |
| Moula |
| National Australia Bank (NAB) |
| OnDeck |
| Payton Capital |
| Reserve Bank of Australia (RBA) |
| Scottish Pacific |

B. Data used in the analysis

The analysis on small and medium enterprises' (SMEs') use of debt finance was based on firm-level microdata from the Business Longitudinal Analysis Data Environment (BLADE) for Australian businesses,²² and the European Commission (EC) and European Central Bank (ECB) Survey on the access to finance of enterprises (SAFE) for European businesses.

This appendix describes these datasets and how they were used, including the construction of variables and data issues. Additional analysis, including figures referred to in the report, is also included.

B.1 BLADE data for Australian SMEs

BLADE contains unit-record data on active businesses from 2001-02 to 2018-19 sourced from:

- the ABS Business Register (ABSBR)
- the Australian Taxation Office (ATO) — business activity statements, business income tax (BIT) filings and pay as you go (PAYG) summaries
- ABS surveys such as the Business Characteristics Survey (BCS) and others (including those related to research and development and economic activity)
- Intellectual Property Australia — Intellectual Property Longitudinal Research Data
- the Department of Foreign Affairs and Trade — merchandise trade data (ABS 2021a).

Data contained in these administrative datasets and surveys can be linked using a unique identifier for each business.

Administrative datasets, such as the BIT database, have annual records from 2001-02, but the availability of survey data depends on the years in which each survey was conducted. For example, the BCS has information from 2005-06. This study focuses on 2018-19²³ and mainly uses data from BIT filings and the BCS, with some additional information sourced from the ABSBR and PAYG summaries.

²² The BLADE contains Australian Business Register data supplied by the Registrar to the ABS under *A New Tax System (Australian Business Number) Act 1999 (Cth)* and tax data supplied by the Australian Taxation Office (ATO) to the ABS under the *Taxation Administration Act 1953 (Cth)*. These Acts require that such data are only used for the purpose of carrying out functions of the ABS. No individual information collected under the *Census and Statistics Act 1905 (Cth)* is provided back to the Registrar or ATO for administrative or regulatory purposes. Any discussion of data limitations or weaknesses is in the context of using the data for statistical purposes, and is not related to the ability of the data to support the Australian Business Register or ATO's core operational requirements. Legislative requirements to ensure privacy and secrecy of this data have been followed. Only people authorised under the *Australian Bureau of Statistics Act 1975 (Cth)* have been allowed to view data about any particular firm in conducting these analyses. In accordance with the *Census and Statistics Act 1905 (Cth)*, results have been confidentialised to ensure that they are not likely to enable identification of a particular person or organisation.

²³ There were some exceptions to this (if the relevant variables were not available in the 2018-19 BCS).

- The BCS was used to examine application and success rates for debt finance and the characteristics associated with debt applications (purpose of debt finance, lender approached and product applied for).
- The BIT filings' balance sheet information and income data were used to generate financial variables (assets and turnover).
- The ABSBR was used for information on businesses' industry and years of operation.
- PAYG summaries were used for information on businesses' number of employees.

An unweighted database was used in the analysis as there are no weights to adjust the sample.

BCS data

The BCS is an annual ABS survey that collects information on a range of variables, including a business's employment, turnover and age, as well as competition and innovation. Of specific relevance to this study are variables on whether a business sought debt finance, the purpose of that finance and whether it was successful in obtaining finance.

The BCS data in BLADE had a sample of about 8000 businesses in 2018-19. Although the survey covers most industries and business sizes across the economy, larger firms were over-represented — nearly 25 per cent of the sample was defined as large using either an employment or turnover definition, compared with about 1 per cent across the economy (chapter 1). The BCS excludes several types of businesses, including:

- those in some industries; for example, public administration and safety, education and training, financial asset investing and superannuation funds and religious services (ABS 2021b)
- businesses without any registered employees (for example, sole traders and individuals), although employing businesses can sometimes have zero employees:

The frame for the BCS is a subset of the ABSBR and includes employing businesses only.

These are defined as those businesses which register for the ATO's Pay As You Go Withholding (PAYGW) scheme. It is not unusual for some of these 'employing businesses' to have zero employment at various times during the reporting period. (ABS 2021b)

BIT filings data

The BIT database includes information submitted by businesses when reporting their annual taxable income to the ATO. Four types of businesses report taxable income: companies, partners and partnerships, individuals (including sole traders) and trust beneficiaries.

There were about 2.47 million SMEs in the BIT database in 2018-19, defined as businesses with turnover of less than \$50 million.²⁴ Of these SMEs, most described themselves as individuals (sole traders) (about 42 per cent), followed by companies (35 per cent), trusts (14 per cent) and partnerships (9 per cent).

The Commission used the total assets reported in the BIT filings to estimate the value of SMEs' assets.²⁵ This item was not required to be provided by individuals, and some companies, trusts and partnerships also did not report their total assets. As a result, nearly half of the SMEs in the BIT database were not able to be included in

²⁴ Turnover was estimated using reported total business income. Observations without turnover information were dropped from the dataset.

²⁵ Assets were reported by business type. There were very few occasions where a business reported assets across more than one business type. In these instances, the value of assets across all business types were added together to estimate that business's total assets.

the analysis of assets (chapter 2). Those businesses that could be analysed were classified as either 'high asset' SMEs or 'low asset' SMEs, based on whether they had assets above or below the median value.

Linking BIT and BCS data

Data from the BIT filings and the BCS were linked using each business's unique identifier, resulting in about 5800 SMEs in the joint BIT-BCS database.²⁶ As noted above, the BCS did not survey sole traders and individuals, so these were significantly under-represented in the merged database; in addition, companies were more over-represented than the other business types.

The values for median assets were estimated using the BIT database. However, because the BCS is a much smaller subsample of the BIT database, when they were merged the resulting database did not have an equal distribution of businesses by assets. That is why the subsample sizes for results reported by asset groupings in chapter 2 (the number of observations in the high asset and low asset categories) were not the same.

Results for Australian SMEs using BLADE

In this study, the Commission used BLADE data to analyse *correlations* between debt applications, success rates and other features, rather than ascribe *casual* relationships. The results should be interpreted as identifying the characteristics of SMEs that were more or less likely to apply for and obtain debt finance, not as identifying factors that increase or decrease the likelihood of applying for and obtaining debt finance. Relatedly, there are various external factors (such as macroeconomic conditions) that influence whether SMEs apply for debt finance, and the extent to which these factors affect different SMEs' decisions differently has not been specifically modelled in this study.

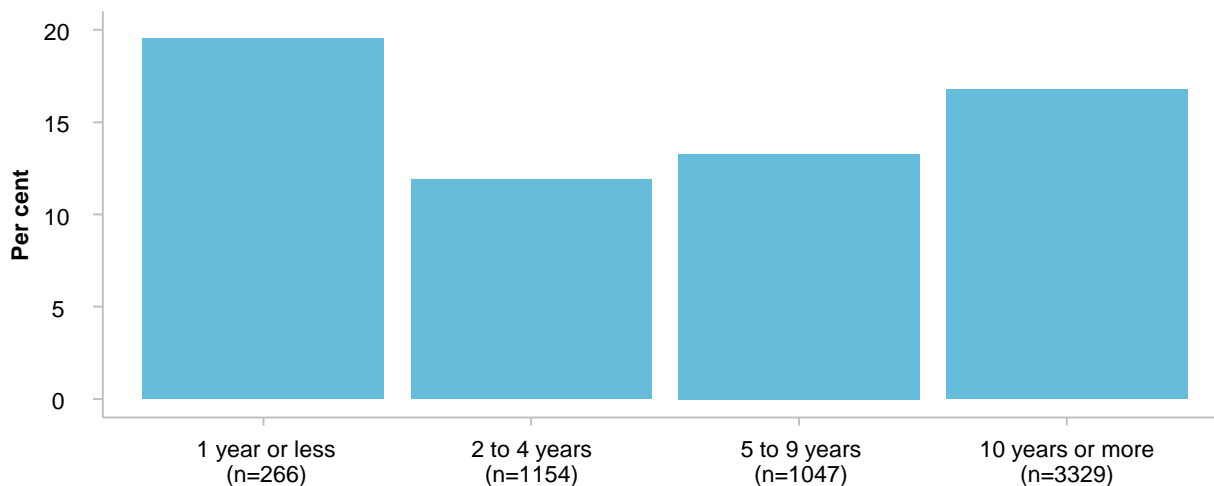
This section provides further information to the discussion in chapters 1 and 2, regarding how Australian SMEs' use of debt finance varied by characteristics such as their size, age, industry and purpose for applying for finance.

Debt finance application rates, by SME age

In 2018-19, the youngest SMEs (aged less than two years) had the highest debt finance application rates. For SMEs aged two or more years, application rates increased with age (figure B.1).

²⁶ As noted above, SMEs were defined as having less than \$50 million in turnover, as reported in the BIT database. The BCS also reports turnover, but that value was not chosen because the response to the survey questionnaire is an estimate, and therefore not expected to be as accurate as records from the BIT filings (which are likely to be audited or more thoroughly verified before being submitted to the ATO).

Figure B.1 – The youngest and oldest SMEs were more likely to apply for debt finance
Share of SMEs that applied for debt finance, by age, 2018-19^a



a. n is the total number of SMEs in the sample in each category.

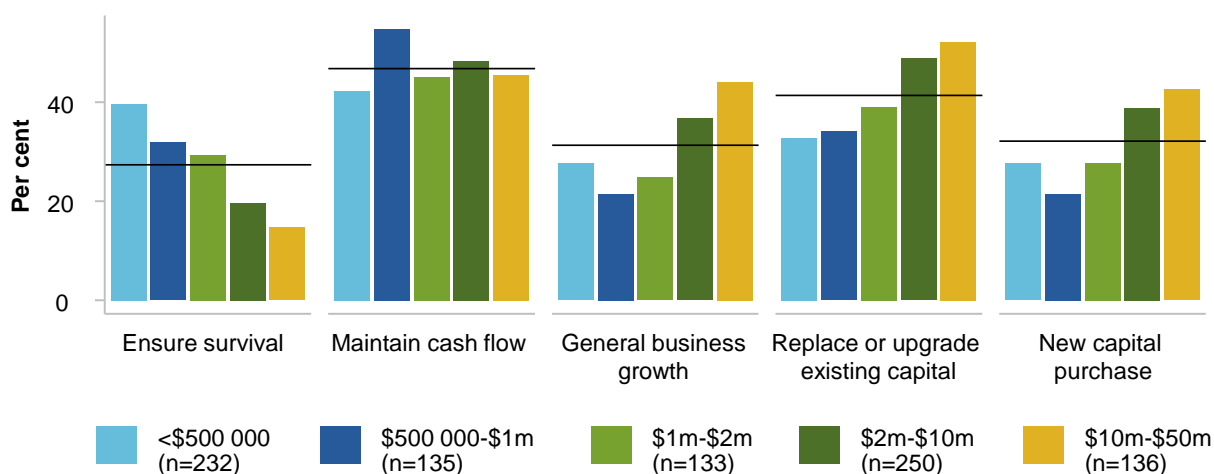
Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Purpose of finance, by SME size and industry

Of those SMEs that sought debt finance in 2018-19, maintaining short-term cash flow or liquidity was consistently cited by SMEs of all sizes as a reason for applying for debt (figure B.2). Larger SMEs were relatively more likely to cite general business growth and replacing, upgrading or purchasing capital as reasons for applying for debt finance. Smaller SMEs were much more likely than larger ones to seek finance to ensure the survival of their business.

Figure B.2 – Smaller SMEs were more likely to need finance for survival; larger SMEs for expansion

Share of SMEs citing each reason for applying for debt finance (of all SMEs that applied for debt finance), by turnover, 2018-19^{a,b,c}



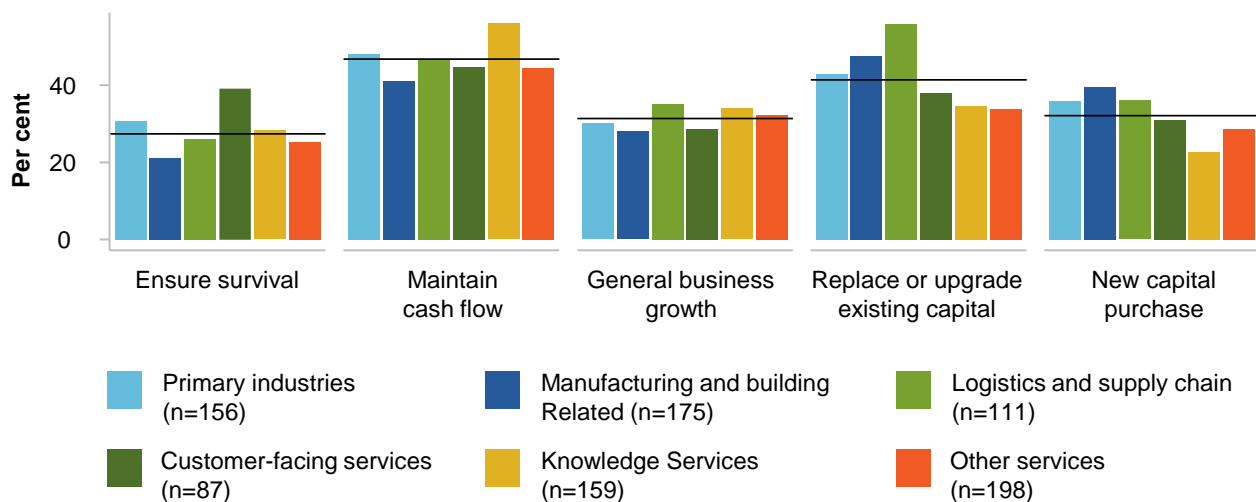
a. Black horizontal lines represent the share citing each reason across all SMEs. b. SMEs could select one or more reasons for applying for debt finance. c. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey, and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Businesses' reasons for seeking finance did not vary much by industry, and SMEs across all industries cited a range of reasons for applying for debt finance. SMEs in service industries were slightly less likely to require debt finance for purchasing, replacing or upgrading capital, consistent with them having less need for physical assets (figure B.3). And SMEs in knowledge services were slightly more likely than those in other industries to nominate maintaining cash flow as relevant to their debt finance applications.

Figure B.3 – SMEs outside of the service industries were most likely to apply for finance for capital-related reasons

Share of SMEs citing each reason for applying for debt finance (of all SMEs that applied for debt finance), by industry, 2018-19^{a,b,c}



a. Black horizontal lines represent the share citing each reason across all SMEs. b. SMEs could select one or more reasons for applying for debt finance. c. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the ABS Business Register, the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

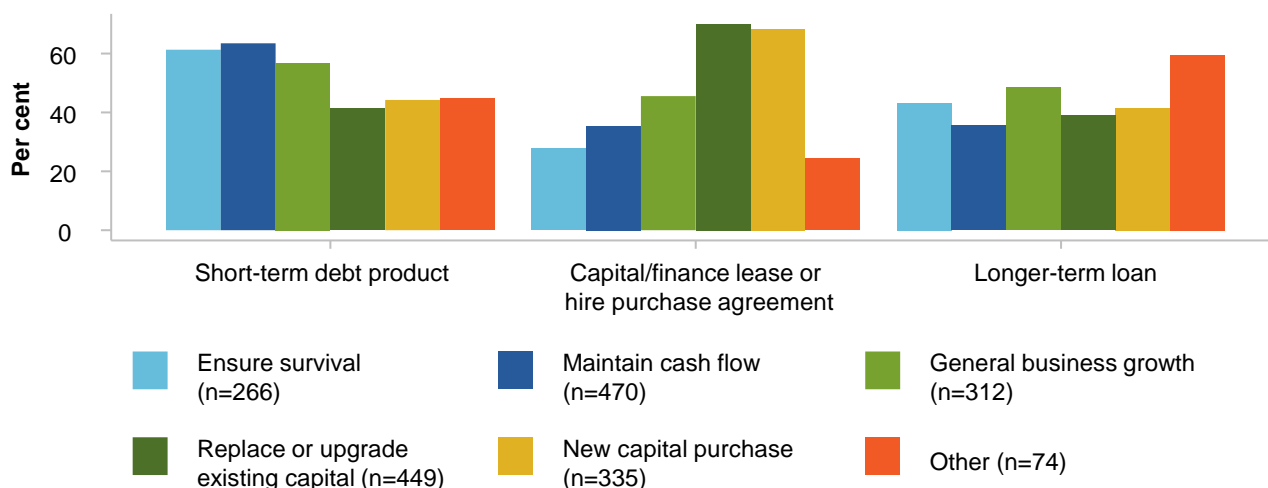
Debt product applied for, by purpose of finance and SME size

The types of debt products sought by SMEs were generally matched to the purpose for which that borrowing was required. For example, in 2017-18, SMEs with shorter-term capital needs such as ensuring survival and maintaining cash flow were more likely to apply for short-term debt products than those seeking debt for other purposes (figure B.4). Meanwhile, those requiring finance to fund the purchase, replacement or upgrade of capital stock were much more likely to apply for capital or finance lease or hire purchase agreements.

Of those SMEs that applied for debt finance, demand for longer-term loans was broadly consistent across different business sizes. However, larger SMEs that sought debt finance were more likely than smaller ones to apply for capital or finance leases or hire purchase agreements (figure B.5).

Figure B.4 – Short-term debt products were used for ensuring survival and maintaining cash flow

Share of SMEs that applied for each debt product (of all SMEs that applied for debt finance), by reason they cited for applying for debt finance, 2017-18^{a,b}

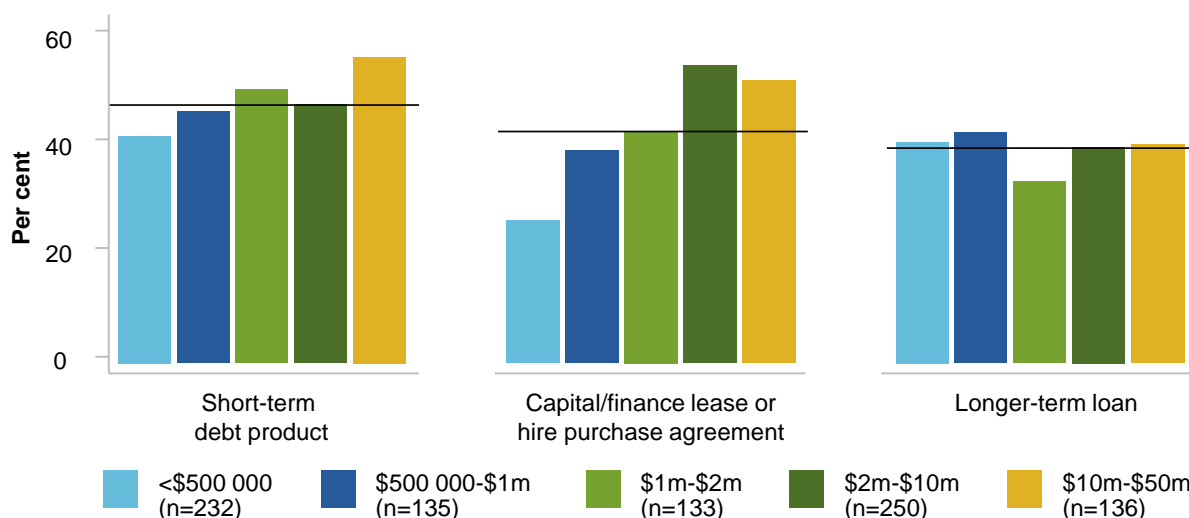


a. SMEs could cite one or more reasons for applying for debt finance, and apply for one or more debt products. b. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Figure B.5 – Larger SMEs were more likely to apply for capital lease or hire purchase agreements

Share of SMEs that applied for each debt product (of all SMEs that applied for debt finance), by turnover, 2017-18^{a,b,c}



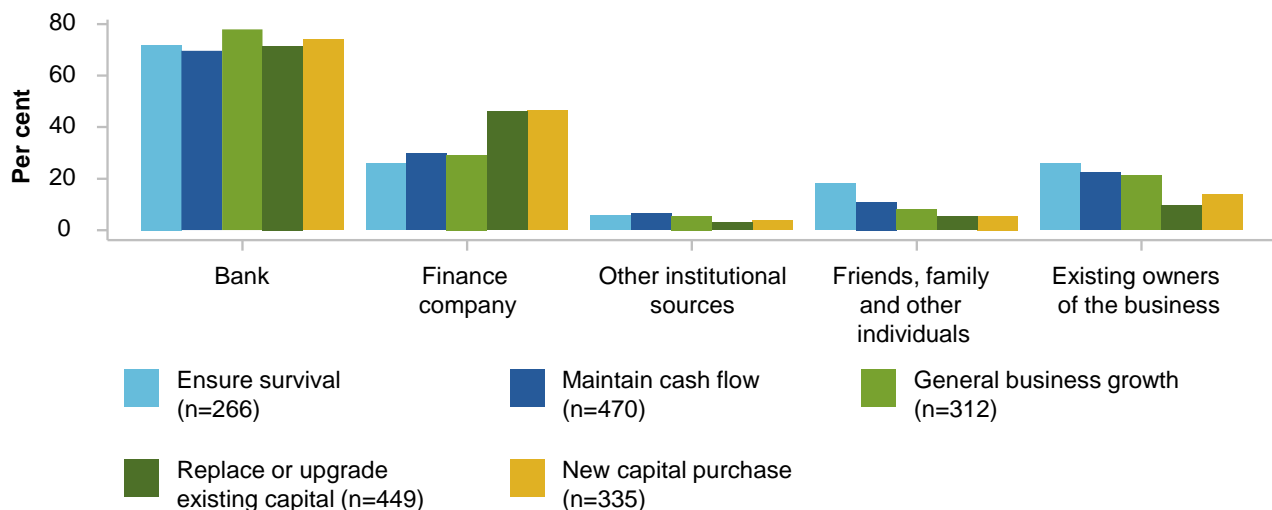
a. Black horizontal lines represent the share applying for each debt product across all SMEs. b. SMEs could apply for one or more debt products. c. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Lender approached, by purpose of finance and SME size

Depending on the purpose of finance, SMEs tended to approach different types of lenders. In 2017-18, SMEs that sought debt finance to purchase, replace or upgrade their capital stock were more likely to approach a finance company, compared with SMEs requiring finance for other purposes (figure B.6). In contrast, SMEs needing debt finance for shorter-term needs, particularly to ensure survival, were relatively more likely to draw on existing owners of the business or family and friends — although banks were still the most frequently approached source overall for these SMEs.

Figure B.6 – Finance companies were more commonly approached for capital-related purposes
Share of SMEs that approached each lender (of all SMEs that applied for debt finance), by reason they cited for applying for debt finance, 2017-18^{a,b,c}



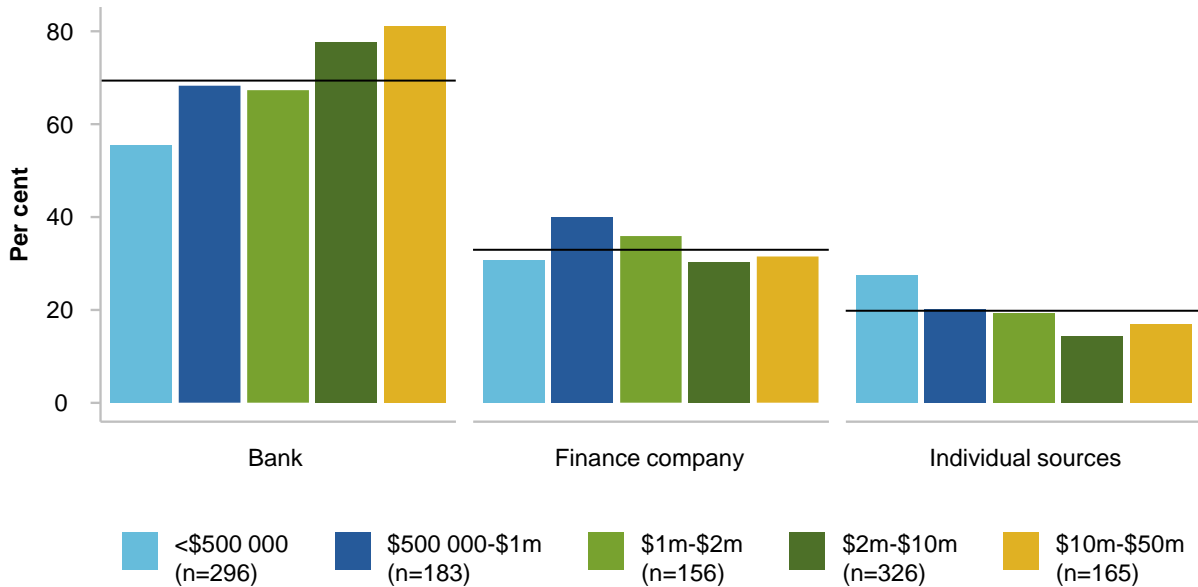
a. 'Other institutional sources' includes other businesses and other. **b.** SMEs could approach one or more lenders, and select one or more reasons for applying for debt finance. **c.** n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Banks were the most frequently approached lenders by SMEs applying for finance regardless of SME size. However, there were some differences in the types of lenders approached, depending on SME size. Larger SMEs that sought debt finance were more likely to approach banks than smaller ones (figure B.7). In contrast, smaller SMEs that sought finance (particularly those with less than \$500 000 turnover) were more likely than larger SMEs to approach individual sources such as family, friends and existing owners.

Figure B.7 – Larger SMEs were more likely to approach banks for debt finance; smaller SMEs to use individual sources

Share of SMEs that approached each lender (of all SMEs that applied for debt finance), by turnover, 2017-18^{a,b,c,d}



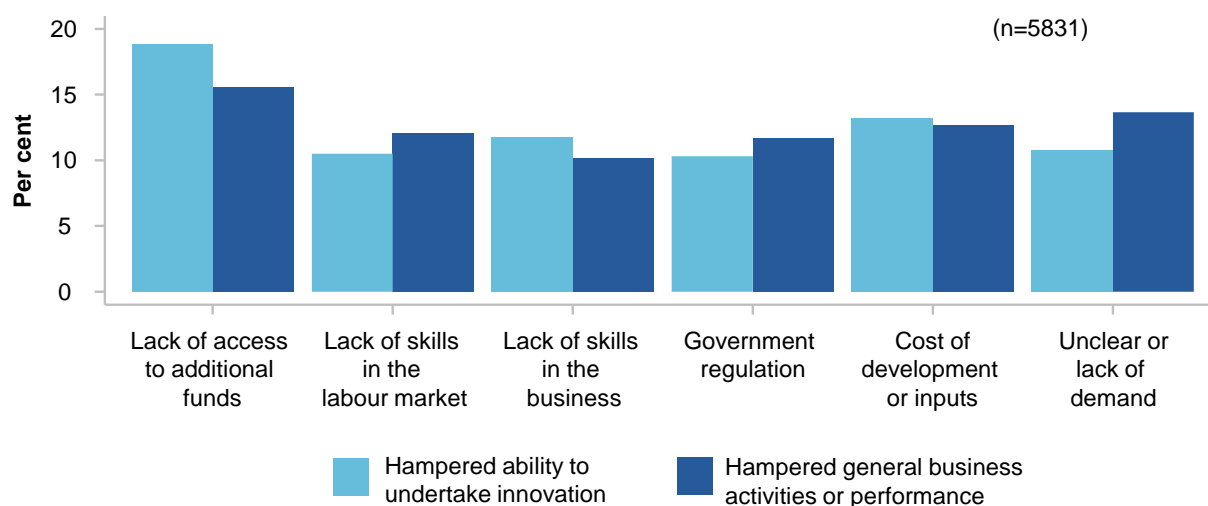
a. Black horizontal lines represent the share approaching each lender type across all SMEs. b. SMEs could approach one or more lenders. c. 'Individual sources' include existing owners of the business, friends and family, and other individuals. These were aggregated due to sample size constraints. d. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

Factors hampering SMEs' activities

As discussed in chapter 2, lack of access to additional funds was one of several factors cited by SMEs as significantly hampering their general business activities or ability to undertake innovation (figure B.8).

Figure B.8 – Lack of access to additional funds hampered some SMEs' activities
Share of SMEs that nominated each factor as significantly hampering their operations, 2018-19^{a,b}



a. n is the total number of SMEs for which this question may have been relevant (that is, the number of SMEs in the sample). **b.** SMEs could nominate one or more factors.

Source: Commission estimates using the Business Characteristics Survey and business income tax datasets in the Business Longitudinal Analysis Data Environment (BLADE).

B.2 SAFE data for European SMEs

Data from the EC/ECB SAFE were used to examine the use of debt finance by European SMEs and, where possible, examine similarities with Australian SMEs. However, data issues (discussed below) limit the ability to make detailed comparisons between Australian and European SMEs.

The SAFE provides unit-record data on the need for, and availability of, external financing of businesses between 2009 and 2020. Two survey rounds are conducted each year, alternating between including a limited number of European countries and including all European Union countries plus some neighbouring countries (ECB 2020, p. 4). This study primarily uses the reference period of the six months to September 2019, which was the latter type of survey and included about 18 000 businesses surveyed across 36 countries (EC 2019, p. 154).

Limitations of SAFE data analysis

While the SAFE contains detailed information on access to finance for European businesses, several factors affect the direct comparability of the BLADE and SAFE data.

- Only a small number of lending variables in the SAFE are broadly consistent with those in the BCS, such as the application for finance and obtaining finance variables. In addition, the BCS measure of debt finance includes loans, bank overdrafts, lease or hire agreements and credit cards, while the SAFE measure relates specifically to bank loans.
- The Commission defined Australian SMEs as businesses with less than A\$50 million in turnover (consistent with the Australian Prudential Regulation Authority's definition). The closest comparable

turnover range in the SAFE data was firms with less than €50 million in annual turnover, which was used to identify European SMEs.

- The industry breakdown in the SAFE is limited. There are only four available categories — industry, construction, trade and services — and they exclude several industries including agriculture, financial and insurance services, public administration and defence and education (ECB 2020, pp. 7–8).
- The SAFE does not contain information on businesses’ assets.

Results for European SMEs

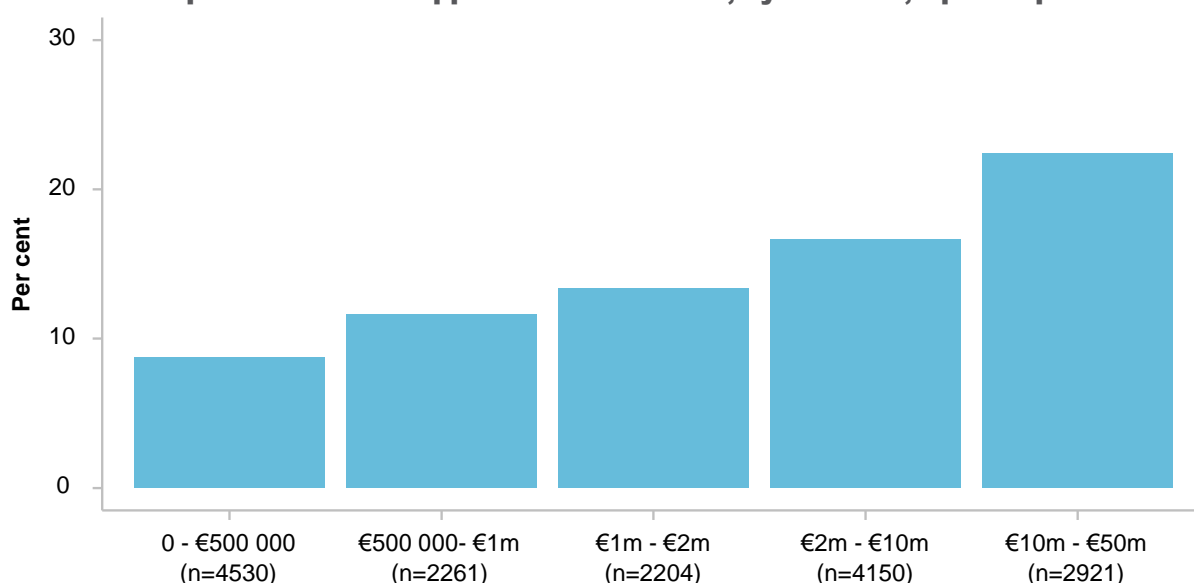
As discussed in chapter 1, larger European SMEs had higher bank loan application rates than smaller ones in the six months to September 2019 (figure B.9). The youngest and oldest European SMEs (aged one year or less, and 10 years or more) had the highest loan application rates; for SMEs aged two years or more, application rates increased with age (figure B.10). These patterns were similar for Australian SMEs that sought debt finance; however, there was a lot of variation by country for some results. For example, over the reference period, 5 per cent of Danish SMEs applied for bank loans, compared with 24 per cent of French SMEs (figure B.11).

Notwithstanding these country-by-country variations, loan application rates appear to be higher among European SMEs (overall) than Australian SMEs, when examining a comparable 12-month period. In the six months to September 2019, 14 per cent of European SMEs applied for a bank loan — but the data that are available for a smaller subset of European countries indicate that the SME loan application rate over the 12 months to September 2019 could be about 1.5 times higher than the six month rate. This would suggest a higher application rate for European SMEs than that observed for Australian SMEs applying for debt finance in 2018-19 (15 per cent).

However, it should be noted that observing a 12-month period using the SAFE requires combining two six-month reference periods, which significantly reduces the number of European countries and number of observations included in the sample, and may impact the reliability of the results.

Figure B.9 – Larger European SMEs have higher loan application rates

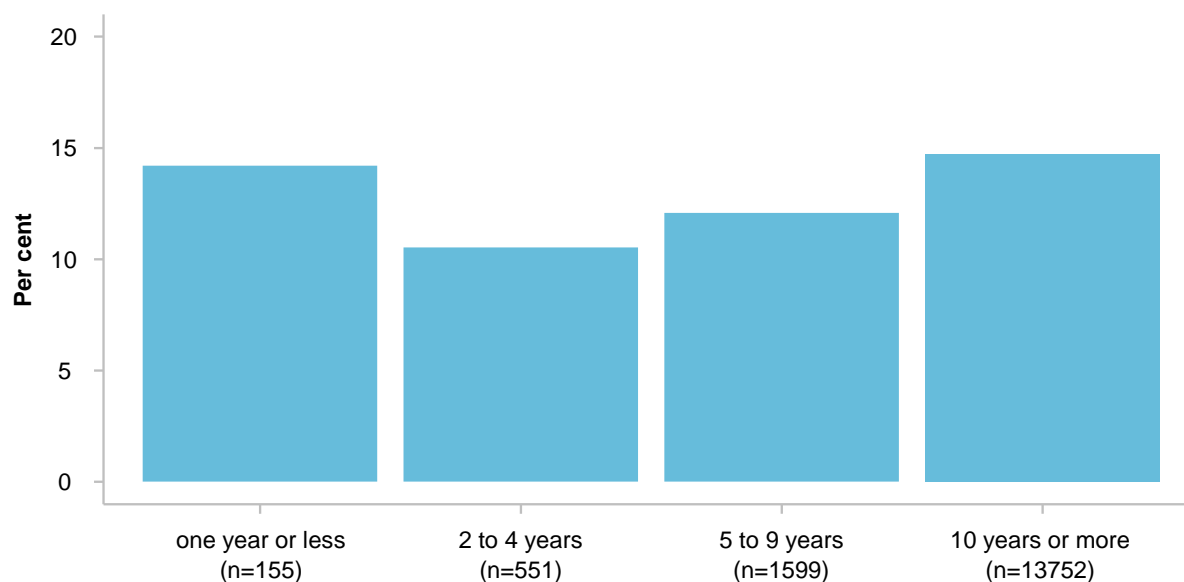
Share of European SMEs that applied for bank loans, by turnover, April–September 2019^{a,b}



a. Weighted averages calculated across all European countries included in the SAFE in the April to September 2019 reference period. b. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using data from the EC/ECB Survey on the access to finance of enterprises (SAFE).

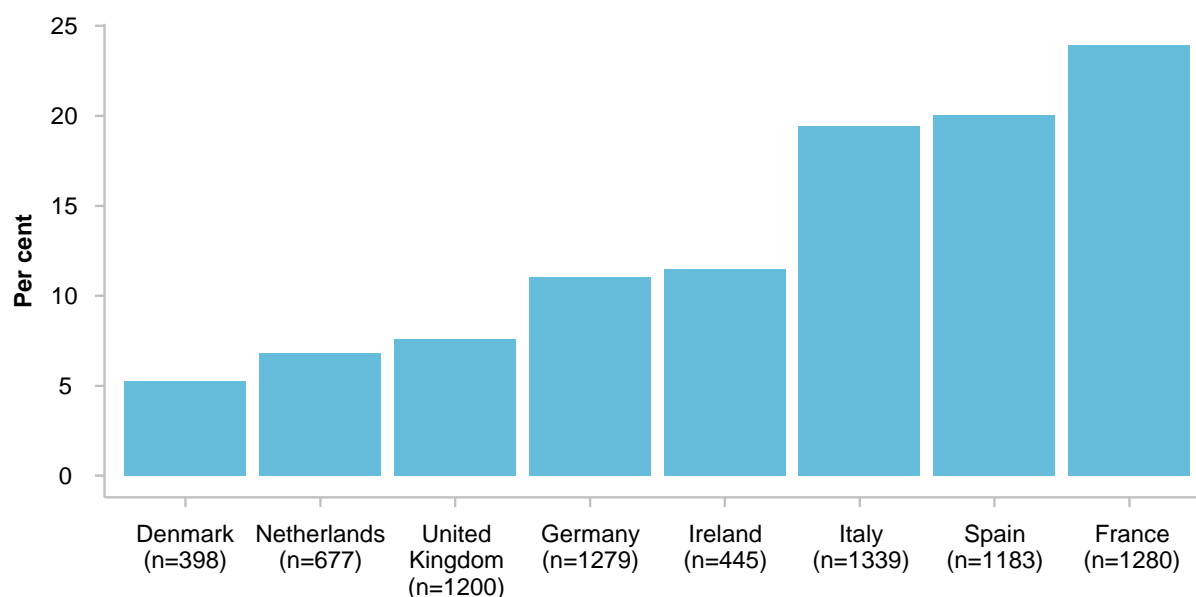
Figure B.10 – The youngest and oldest European SMEs were more likely to apply for loans
Share of European SMEs that applied for bank loans, by age, April–September 2019^{a,b}



a. Weighted averages calculated across all European countries included in the SAFE in the April to September 2019 reference period. b n is the total number of SMEs in the sample in each category.

Source: Commission estimates using data from the EC/ECB Survey on the access to finance of enterprises (SAFE).

Figure B.11 – SME loan application rates vary significantly across European countries
Share of SMEs that applied for bank loans, by country, April–September 2019^a



a. n is the total number of SMEs in the sample in each category.

Source: Commission estimates using data from the EC/ECB Survey on the access to finance of enterprises (SAFE).

Abbreviations

| | |
|----------------|--|
| ABS | Australian Bureau of Statistics |
| ABSF | Australian Business Securitisation Fund |
| ADI | Authorised deposit-taking institution |
| AOFM | Australian Office of Financial Management |
| APRA | Australian Prudential Regulation Authority |
| ASX | Australian Securities Exchange |
| ATO | Australian Tax Office |
| BLADE | Business Longitudinal Analysis Data Environment |
| CDR | Consumer Data Right |
| EC | European Commission |
| ECB | European Central Bank |
| GSA | General security agreement |
| LVR | Loan-to-value ratio |
| OECD | Organisation for Economic Co-operation and Development |
| PC | Productivity Commission |
| RBA | Reserve Bank of Australia |
| R&D | Research and development |
| SAFE | Survey on the access to finance of enterprises |
| SFSF | Structured Finance Support Fund |
| SME | Small and medium enterprise |
| SSA | Specific security agreement |

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