Australian Government

Australian **Small Business** and **Family Enterprise** Ombudsman

21 September 2017

Commissioner Peter Harris AO
Chairman
Competition in Australia's Financial System inquiry
Productivity Commission
GPO Box 1428
Canberra ACT 2610

By email: financial.system@pc.gov.au

Peter

Dear ~~Commissioner Harris~~

RE: INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

Thank you for the opportunity to submit comments to the Inquiry into Competition in the Australian Financial System.

The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) advocates for small business and family enterprise on relevant policies, practices and legislation that impact on small business and family enterprise. As a general comment on the financial system, our own inquiry into small business loans in 2016 found that there was almost a complete asymmetry of power in the relationship between banks and small business borrowers.[1] Some of this imbalance has, and continues to be, addressed through legislative changes to unfair contract terms and action in relation to the Code of Banking Practice. More still needs to be done. To that end, we will soon be issuing a scorecard assessing progress against the recommendations from our small business loans inquiry report.

We have focussed our submission to address the terms of reference related to "the nature of competition in the provision of credit and financial services for small and medium sized enterprises". We approach this issue from the perspective of access to finance for small business and family enterprise. This is a constant theme in our discussions with small business.

Our work in this area has identified that there are two structural factors which constrain access to finance for small business. Firstly, since the Global Financial Crisis (GFC), Australia's prudential rules have focussed more on overall banking system stability. The trickledown effect of this focus has led banks, particularly the large banks, to focus lending against real property security rather than financial aspects of a small business such as cash flow. Secondly, other potential sources of investment, such as superannuation funds, have been pushed by a combination of

[1] http://www.asbfeo.gov.au/sites/default/files/030217-ASBFEO_Report.pdf

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regulation and market forces into a focus on funds minimising fees and investing in liquid assets rather than other investment options.

Access to finance: prudential rules and biases in the banking system

The prevailing focus of bank lending against real property security has the effect of increasing the cost of capital on other lending. It has also contributed to reducing the ability of small business to obtain funding secured against other business aspects such as cash flow. This outcome may not represent market failure in a strict sense as banks are factoring risk into their lending practices. It does have an impact on limiting finance to small businesses that have no or limited access to real property. Consequently, whilst the current prudential regulatory environment and capital holding rules have ensured Australia has a stable financial system on an international scale, this has been at a real cost to the financing options available to small business and family enterprise. The focus on 'bricks and mortar' funding is constraining capital for businesses with good cash flow and business prospects, but lacking in real property holdings that may be mortgaged. As a result, for many small businesses funding is simply unavailable at a reasonable cost.

There are a growing number of alternative non-bank funding providers who are seeking provide finance to small businesses who don't meet the banks requirements. This is in the form of new entrants like investment bank Houlihan Lokey[2] or smaller fintechs seeking to fill the gap. Notwithstanding the changes taking place in the financial market, we would recommend the Productivity Commission explore the extent to which prudential risk weighting standards and capital requirements are 'too tight' from a risk perspective and consequently affecting the appetite for large banks to fund small business. An alternative option is for a Government-backed approach to small business lending such as the Commonwealth Government Clean Energy Finance Corporation (CEFC). The fund was set up because of the barriers to entry into clean energy and the need for a bank-friendly business case in order to entice banks to lend in this area. Banks and the CEFC share the risk on these loans. It could be a useful model for government-backed small business loans, similar to the British Business Bank.[3]

Access to finance: superannuation regulation

We recently conducted research based on feedback from the small business sector which suggested Australian superannuation funds seek to reduce costs by investing in large offshore investments rather than small Australian investments. This was due to superannuation regulation focussing funds on being able to publicise low fees. At the same time, liquidity requirements mean that investment is biased more favourably to liquid assets such as traded securities. The end result is that Australian superannuation funds overlook the potential for investment via the private equity or venture capital markets.

[2] The Australian, Business Review, 'Shadow lenders are starting to fill a gap in the banking market', 12 September 2017

[3] British Business Bank (http://british-business-bank.co.uk/)

Our research identified constraints on attracting domestic and foreign capital for private equity and venture capital initiatives with local demand outstripping supply. It is estimated that foreign superannuation and pension funds dominate the private equity pool in Australia with Australian funds seeking investment stakes in foreign markets. The question our research raised was whether there are market imperfections that limit the ability (and desire) for Australian superannuation funds to invest here?

There is some evidence that suggests the bias in Australian funds investing in foreign markets do so to reduce risk, by taking smaller stakes in a number of (large) investments. This reduces administrative overheads and requirements to manage a larger number of investments compared to investing in Australia. We would recommend the Productivity Commission explore whether there are impediments to investment by Australian superannuation funds in the Australian private equity and venture capital markets, which in turn could become a source of competition for banks in financing small business.

Alternative sources of finance

We recognise that other forms of finance are emerging. For example, crowd-funding and other non-bank ADIs, including the fintech industry are entering the market as an alternative source of finance . In the UK for example, many so-called challenger banks have emerged to address funding gaps, to a much greater extent than in Australia. These challenger banks include a number that focus on SME lending and offer a wide range of services using different technologies and platforms. As recently as November 2016, the House of Representatives Standing Committee's first review of the four major banks[4] suggested that there were high barriers to entry that act as impediments to new bank entrants in the Australian market. Consequently, the Government has begun looking at the matter including the use of the term 'bank' and the related capital requirements.

Despite the presence of alternative sources of funding in Australia, the growth in the number and variation of fintech products has made it difficult for small business to make informed decisions about which products and lenders will suit their circumstances. For trust and confidence in alternative lending to grow, there needs to be an industry focus on transparency and disclosure. In this context, the cost of finance needs to be clearly defined with fees and charges clearly identified over the life of a loan. Our office has been working with fintech industry bodies to examine these issues and has recently completed a survey on this topic.

Unfair Contract Terms and the financial industry

Lastly, we have concerns regarding unfair contract terms in standard form contracts in the finance industry. In conjunction with the Australian Securities and Investment Commission (ASIC), we have examined the large banks' steps to remove unfair

[4] House of Representatives Standing Committee's First Report into the Review of the four major banks, pg 34, http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Four_Major_Banks_Review/Report

contract terms from their standard form contracts. Whilst significant progress has been made with the large banks, there approach is not uniform and there is still work to be done in eliminating these terms from contracts of other participants in the finance industry. The fact that unfair contract terms persist reflects the complexity and lack of transparency in standard form contracts used across the industry. Recent research by this office suggests that industry awareness of the unfair contracts legislation is not universal. This is important to competition in the finance industry as unfair contract terms reflect the asymmetry of power in the relationship between a bank and its customer. Eliminating these terms will foster a fairer relationship between customer and bank.

The issues we have raised have been brought to our attention by small business or uncovered during the course of our own inquiries and research. We trust that the Productivity Commission inquiry will explore these issues in more detail. We hope these comments assist your deliberations. Please feel free to contact either myself or Mr James Strachan,

Yours sincerely,

Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman