Australian Government
Productivity Commission

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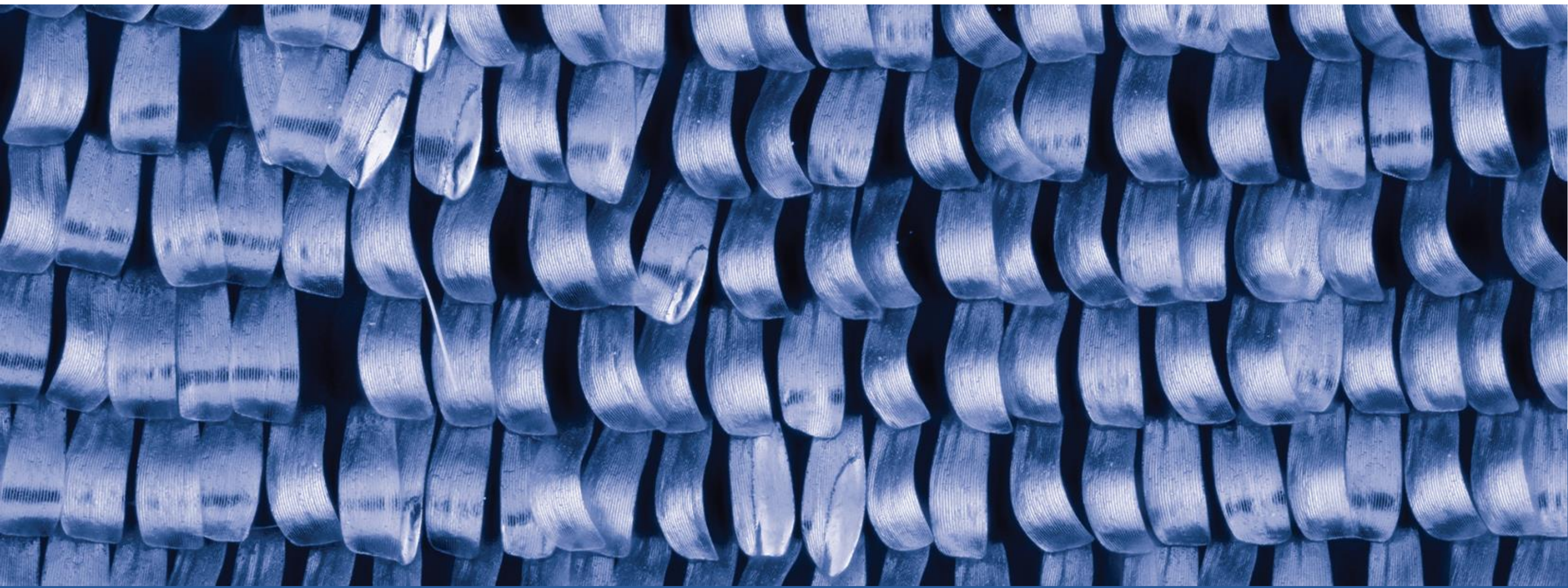

Australian Business Securitisation Fund Review

Productivity Commission submission

The Productivity Commission acknowledges the Traditional Owners of Country throughout Australia and their continuing connection to land, waters and community. We pay our respects to their Cultures, Country and Elders past and present.

The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

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Productivity Commission submission to the ABSF Review

Background: the Small and Medium Enterprise (SME) lending market

The Productivity Commission recently published a report entitled *Small Business Access to Finance: the Evolving Lending Market*. The report found that a number of new lenders had entered the business lending space.

New entry was possible for two reasons. First, the major banks significantly expanded their mortgage lending, relative to business lending. The banks' focus on mortgage lending may have led to some unmet demand for business lending. Second, new lenders innovated in their use of big data to better identify 'good' borrowers, and new sources of data became available (such as comprehensive credit reporting and real-time transaction data from accounting software).

The result is that some SMEs can now access unsecured loans of up to $250,000, and some SMEs can use a much more flexible mix of assets — such as a mix of business equipment — as security for loans. It is likely that some of those businesses, especially those without real estate assets to use as collateral, were inefficiently credit-constrained before these loans became available. The high interest rates paid by some business borrowers in the unsecured segment also suggests that these loans are urgently needed, although some small business borrowers may be making imprudent choices (as do some consumers).

As these new lenders grow and compete with each other, and as more-established lenders also identify opportunities to lend through these emerging channels, more small businesses will have access to these new types of loans, and the interest rates for good borrowers are likely to come down.

At the same time, the expansion of these new lenders can be limited by their access to capital, which for most new lenders involves sourcing debt or equity funding from investors. Debt funding is available from banks and specialised investors in the form of warehouse funding (a temporary and short-term investment). Once the lending institution has grown in size and reputation, it can also (1) issue securities, backed by a large number of loans, or (2) publicly list its shares. Both these channels offer investors the benefit of diversification.

It is natural, therefore, for government to seek to accelerate the growth of this new segment of the market. However, many missteps are possible in encouraging this segment to expand. In many OECD countries, policies to encourage access to credit for SMEs have backfired, leading to excessive debt levels among less viable SMEs and high costs for government (Lam and Shin 2012, OECD 2015).

How the ABSF can impact SME lending markets

In assessing the impact of the Australian Business Securitisation Fund (ABSF), it is important to recognise that there is no shortage of available capital (except perhaps in periods of acute crisis). A glut of world capital has led to historically low interest rates, even before the global financial crisis, and an active search for higher returns by many investors (Bernanke 2005). Consequently, an initiative such as the ABSF cannot be solving a capital shortage. Investment by the Commonwealth can only be beneficial if it is addressing a market imperfection (for example, the limited availability of information on lenders and their loans); otherwise it merely serves to crowd out other investors.

The ABSF is co-investing in warehouses for banks and other financial institutions that are lending to SMEs. This could indirectly improve information provision for a segment of the market. The Australian Office of Financial Management (AOFM), in administering the ABSF, undertakes due diligence on a lender and its ABSF proposal before investing. Other (private sector) investors may interpret the AOFM's investment decision as a signal about the quality of that lender's portfolio, and be more willing to invest their own capital in that lender's facilities. This potentially increases the flow of funds to certain segments of the market, as the ABSF has concentrated on lenders offering new types of loans for SMEs.

However, it is unlikely that warehouse investments on their own could directly solve major information problems. It would only indirectly provide information for a subset of lenders (that is, lenders that apply and are approved for ABSF investment) and could create competitive distortions. Moreover, the small size of the ABSF relative to the market for business lending means that its investments are unlikely to have a large influence.

More generally, one requirement of ABSF investment proposals is that lenders undertake to collect loan data in accordance with a reporting template developed by the Australian Securitisation Forum. Encouraging lending institutions to adopt a data reporting standard could more directly solve the information problem. Many investors do not have the scale or expertise to evaluate emerging lending institutions. But if these new lenders can provide comprehensive data on their loans in a standardised template, investors may be more able to assess the riskiness of their investment and more willing to provide warehouse funding.

Standardised reporting could also make it easier for new lenders to issue securities that are backed by a portfolio of their loans, as major ratings agencies may use this information to provide a credit rating for these securities, and investors can simply use that credit rating to make their investment decision. Without such reporting, if ratings agencies lack sufficient information on the quality of loans offered to SMEs by new lenders (with the exception of loans secured against familiar assets), securities based on these loans are likely to receive low credit ratings, and investors will require high rates of interest. High interest rates in turn raise the interest rates paid by borrowers.

If instead all lenders report information in the same form, investors and credit agencies can assess the underlying loans backing the securities with comparative ease. Investors and credit agencies can also compare lenders, and individual lenders can build a performance track record. Credit ratings will be higher for securities backed by higher quality loans and issued by lenders with a better performance record, which means those lenders will pay lower interest rates.

The economics of standards suggests that it can be challenging to establish a standard in a market, such as a standard format for loan reporting, even when all parties stand to benefit. There can be excess inertia. In some cases, a standard may not be adopted without the actions of a large firm or a public body (Stango 2004); thus the AOFM may be playing a significant role.

Assessing the impact of the ABSF to date

It is too early to assess the impact of the ABSF. The pandemic and resulting shocks may have slowed the development of the SME credit market; while overall lending to SMEs remained stable (RBA 2021), lenders informed the Commission that unsecured loans of up to $500,000 — which were available prior to the pandemic — are harder to obtain now. These larger loans may resume in the future. The pandemic may also have slowed down the development and adoption of the loan reporting standard.

As mentioned in the ABSF Review Consultation paper, a number of other government initiatives have impacted interest rates and credit availability over recent years: the Structured Finance Support Fund (SFSF), the RBA's historically low cash rate, and the SME loan guarantee scheme. SME lenders have received larger investments from the SFSF during the last two years than from the ABSF, so it would be particularly difficult to disentangle the effects of those two programs.

The Commission understands from the AOFM that several lenders have already adopted the loan reporting standard. It will be useful to track adoption rates for the standard over the next few years, and to review the ABSF effectiveness at that point.

ABSF principles

In our discussions with AOFM, our sense is that they have clearly kept in mind the ABSF guiding principles (additionality, promoting competition, sustainability).

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