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Executive General Manager  
Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority  
GPO Box 9836  
Sydney NSW 2001

By email [ADIpolicy@apra.gov.au](mailto:ADIpolicy@apra.gov.au)

Dear Mr Brennan

### **Revisions to the capital framework for authorised deposit-taking institutions**

The Office of the NSW Small Business Commissioner (OSBC) submits the following comments on the Australian Prudential Regulation Authority's (APRA) discussion paper regarding *Revisions to the capital framework for authorised deposit-taking institutions* (ADIs).

The OSBC is focussed on supporting and improving the operating environment for small businesses throughout NSW. The OSBC advocates on behalf of small businesses in NSW, provides mediation and dispute resolution services, speaks up for small businesses in government and makes it easier to do business through policy harmonisation and regulatory reform.

Small business is the engine room of the NSW economy. NSW is home to 34 per cent of Australia's small businesses, making up 98 per cent of all NSW businesses and employing 1.57 million people, representing almost 50 per cent of the NSW workforce. Ensuring they have access to affordable capital at all stages of the business cycle is crucial to NSW remaining a vibrant and growing economy.

#### **Context of our response**

The OSBC is concerned by the availability of finance for small-to-medium enterprises (SMEs). Capital requirements, as set by APRA, are inextricably linked with the costliness of, and appetite for, lending.<sup>1</sup>

Australian Bureau of Statistics (ABS) data highlights that only 12.2 per cent of businesses with less than 5 employees sought debt or equity finance in 2015-16. Of those who did seek equity, half were not successful.<sup>2</sup>

This problem is exacerbated by the traditional lenders insisting that the majority of SME lending being secured. The Reserve Bank of Australia has found at least three-quarters of small business lending is collateralised. They outline several reasons why small business operators may find providing this collateral difficult, including:

- a young entrepreneur may not own a home or hold much equity in their home,
- if they've already borrowed to purchase their home, they may not have enough equity with which to borrow against, and;
- even if they do have sufficient equity, using their home as collateral concentrates the risk they face.<sup>3</sup>

The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) have also noted these issues. They highlight that young entrepreneurs increasingly turn to parents for seed finance, which in turn puts retirement savings at risk and means that children of affluent parents have greater opportunities to start and operate a business.<sup>4</sup>

<sup>1</sup> Productivity Commission (2018). *Draft report: Competition in the Australian financial system*. p.9.

<sup>2</sup> ABS, *Selected Characteristics of Australian Business (Business Finance)*, 2015-16, cat. No. 8167.0

<sup>3</sup> Kent, C. (2018). *The Availability of Business Finance | Speeches | RBA*. [online] Reserve Bank of Australia. Available at: <https://www.rba.gov.au/speeches/2017/sp-ag-2017-12-13.html>

<sup>4</sup> The Australian Small Business and Family Enterprise Ombudsman (2017). *Barriers to Investment*. p.2.

The OSBC views this as an economic opportunity missed. SMEs should be enabled to grow their business and create jobs through innovation. Access to finance plays a pivotal role in the ability of businesses to achieve this.

Competition in small business lending has been less vigorous than in the large business lending market.<sup>5</sup> Interest rates on small business loans have remained high since the recovery from the Global Financial Crisis and small businesses still rely on bank loans for funding as accessing capital markets is too costly and complex.<sup>6</sup> The Reserve Bank of Australia (RBA) has gone so far as to criticise Australia's major banks for failing to provide "entrepreneurial finance".<sup>7</sup> They have also noted that small businesses around the country "continue to find it challenging to obtain external finance."<sup>8</sup>

In this context, our comments are guided by our ongoing consultations with NSW small businesses and the concerns they have raised with us regarding these issues. Our goal is to increase the ability of small businesses to flourish in NSW and our commentary focusses on areas of the discussion paper relevant to this aim.

### **Standardised approach; small and medium-size enterprise exposures**

The Productivity Commission's draft report on the *Inquiry into Competition in the Australian Financial System*<sup>9</sup> has made recommendations regarding risk weight settings. They propose that APRA implement a broad schedule of risk weights to apply to unsecured SME lending that take into account differing risk profiles and the type of lending.<sup>10</sup>

The OSBC supports this recommendation. A tiered capital requirement for loans to SMEs, based on their differing risk profiles, will increase competition in the lending market and make finance more affordable for small business. This recommendation has received in-principle support from the RBA<sup>11</sup>, the ASBFEO<sup>12</sup>, the Australian Industry Group<sup>13</sup>, the Australian Banking Association<sup>14</sup>, National Australia Bank<sup>15</sup> and the Commonwealth Bank<sup>16</sup>.

Based on this and our conversations with small businesses regarding their difficulties accessing finance, we support APRA's proposal to lower the risk weighting applied to SME exposures not secured by property from 100 per cent to 85 per cent. This recognises that collateral provided as security can take many forms and is not restricted to residential property. We also support the proposal that SME exposures secured by property will vary depending on the loan-to-value ratio of the relevant security.

Together, these changes would ensure a more refined approach to risk weight applied to SME lending.

Implementing the changes proposed would bring Australia closer to other developed nations' capital requirement settings. In Europe, the United Kingdom and Canada the risk rating is set at 75 per cent for small business lending.<sup>17</sup> The OSBC would endorse future changes that brought Australian macro-prudential settings in line with these examples.

### **Internal-ratings based approach; small and medium-size enterprise exposures**

APRA proposes to merge the SME retail and SME corporate asset classes under the internal-ratings based (IRB) approach to credit risk. Under the change, the new SME asset class would apply the risk weight formula of the corporate asset class.

<sup>5</sup> Kent, C. (2018). *The Availability of Business Finance* | Speeches | RBA. [online] Reserve Bank of Australia. Available at: <https://www.rba.gov.au/speeches/2017/sp-ag-2017-12-13.html>

<sup>6</sup> Kent, C. (2018). *The Availability of Business Finance* | Speeches | RBA. [online] Reserve Bank of Australia. Available at: <https://www.rba.gov.au/speeches/2017/sp-ag-2017-12-13.html>

<sup>7</sup> Australian Financial Review. (2017). *RBA says banks are holding back small-business growth*. [online] Available at: <http://www.afr.com/business/banking-and-finance/financial-services/rba-says-banks-are-holding-back-small-business-growth-20171113-gzk6yc>

<sup>8</sup> Eyers, J. (2017). *RBA raises concerns on small business lending*. [online] Financial Review. Available at: <http://www.afr.com/business/banking-and-finance/financial-services/rba-raises-concerns-on-small-business-lending-20171213-h03u0r>

<sup>9</sup> Productivity Commission (2018). *Draft report: Competition in the Australian financial system*.

<sup>10</sup> Productivity Commission (2018). *Draft report: Competition in the Australian financial system*. p.38.

<sup>11</sup> Reserve Bank of Australia (2018). *Supplementary Submission to the Productivity Commission Inquiry into Competition in the Australian Financial System*. p.6.

<sup>12</sup> The Australian Small Business & Family Enterprise Ombudsman (2018). *Submission in response to the Draft Report: Competition in the Australian financial system*.

<sup>13</sup> Australian Industry Group (2018). *Australian Industry Group Submission: Competition in the Australian financial system*. p.8.

<sup>14</sup> Australian Banking Association (2018). *ABA response to the Productivity Commission draft report into Competition in the Australian Financial System*. p.26

<sup>15</sup> National Australia Bank (2018). *Submission; Productivity Commission Inquiry into Competition in the Australian Financial System: Draft Report*. p.14.

<sup>16</sup> Commonwealth Bank (2018). *Final Submission to the Productivity Commission's Inquiry into Competition in the Australian Financial System*. p.33.

<sup>17</sup> This risk weight applies if the portfolio satisfies certain criteria.

See: Productivity Commission (2018). *Draft report: Competition in the Australian financial system*. p.259.

The four major bank lenders in Australia use the IRB approach and account for over 80 per cent of small business lending.<sup>18</sup> ABS data highlights that two thirds of small businesses, defined as those with less than 5 employees, seek debt finance through banks.<sup>19</sup> Given this, any changes to SME exposure under to risk weightings applied under this approach will have widespread effects.

The impact of this change on the average risk weighting of SME lending, and in turn its effect on the appetite for SME lending, is difficult to quantify.<sup>20</sup> The OSBC would not support any change that decreases the appetite of lenders to provide financing to SMEs. SMEs face several structural barriers to accessing finance, and any increase in risk weights would exacerbate this market failure.

### Additional comments

The discussion paper notes that the proposed changes are, in part, attempting to address a concentration of ADI portfolios in residential mortgages. Increasing the appetite for lending to SMEs is an important factor in achieving this goal. The Productivity Commission highlights that APRA's market interventions to date have been blunt in nature, and that a more nuanced approach would address imbalances in lending between businesses and housing.<sup>21</sup>

The Commission also notes:

More generally, they [risk weight settings] create a strong preference for home loan lending over SME lending unsecured by residential property.<sup>22</sup>

APRA should ensure that the finally agreed changes encourage greater diversification of lending, and a rebalancing of ADI incentives to lend.

The OECD's *Financing SMEs and Entrepreneurs 2018* report found that, of 39 OECD member nations, Australia ranked 27th for SME loans as a percentage of all outstanding business loans, representing only 30 per cent of total business lending in 2016. Comparatively, SME lending accounted for over 65 per cent of total business lending in Japan, Belgium, Switzerland and Korea in the same year.<sup>23</sup>

Ensuring an appropriate division of lending by ADIs relates strongly to APRA's mission;

"...to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system."<sup>24</sup>

The OSBC would welcome a response from APRA regarding the proposals and issues raised in this letter.

Should you wish to discuss our comments further, please contact James Davis, Advisor, Office of the NSW Small Business Commissioner on [REDACTED] or [REDACTED]

Yours sincerely



**Robyn Hobbs OAM**  
NSW Small Business Commissioner  
10 May 2018

<sup>18</sup> Kent, C. (2018). *The Availability of Business Finance | Speeches | RBA*. [online] Reserve Bank of Australia. Available at: <https://www.rba.gov.au/speeches/2017/sp-ag-2017-12-13.html>

<sup>19</sup> ABS, *Selected Characteristics of Australian Business (Business Finance)*, 2015-16, cat. No. 8167.0

<sup>20</sup> PWC (2018). *APRA Consultation: Revisions to the Capital Framework*. p.11.

Available at: <https://www.pwc.com/au/campaign/baseliv/revisions-capital-framework-feb18.pdf>

<sup>21</sup> Productivity Commission (2018). *Draft report: Competition in the Australian financial system*. p.2.

<sup>22</sup> Productivity Commission (2018). *Draft report: Competition in the Australian financial system*. p.19.

<sup>23</sup> OECD (2018). *Financing SMEs and Entrepreneurs 2018: An OECD Scorecard*. p.31

<sup>24</sup> APRA (2018). *Pages - About APRA*. [online] Available at: <http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx>