Christopher Kent: The availability of business finance

Speech by Mr Christopher Kent, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, at the 30th Australasian Finance and Banking Conference, University of New South Wales, 13 December 2017.

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I thank Ellis Connolly and Ben Jackman for invaluable assistance in preparing these remarks, which also draw upon an article they have authored: Connolly E and Jackman B (2017), 'The Availability of Business Finance', RBA Bulletin, December, pp 55–66.

It is a pleasure to be here to discuss the availability of business finance in Australia. Businesses need funding for their day-to-day operations and to undertake investment. These funds can be generated internally, from profits, or they can come from various external sources. The availability of funding has an important bearing on current and future economic activity.

My remarks today are structured around three key issues.

First, I'll talk about the internal and external sources of funds and the way in which businesses use those funds. External finance has become available on increasingly favourable terms for large borrowers over recent years, including because of increased competitive pressures in this market. However, for the business sector as a whole, internal funds are the key source of funding for investment. Growth in external funding has only a weak relationship to investment. Debt funding appears to be linked to mergers and acquisitions activity, which has remained relatively modest compared with levels prior to the financial crisis.

The second issue I want to discuss is the experience of entrepreneurs seeking to start or expand a small business. They are typically more reliant on external finance, which remains difficult for them to obtain. Access to finance for such small businesses is important though, since they generate significant employment growth, drive innovation and boost competition in markets.

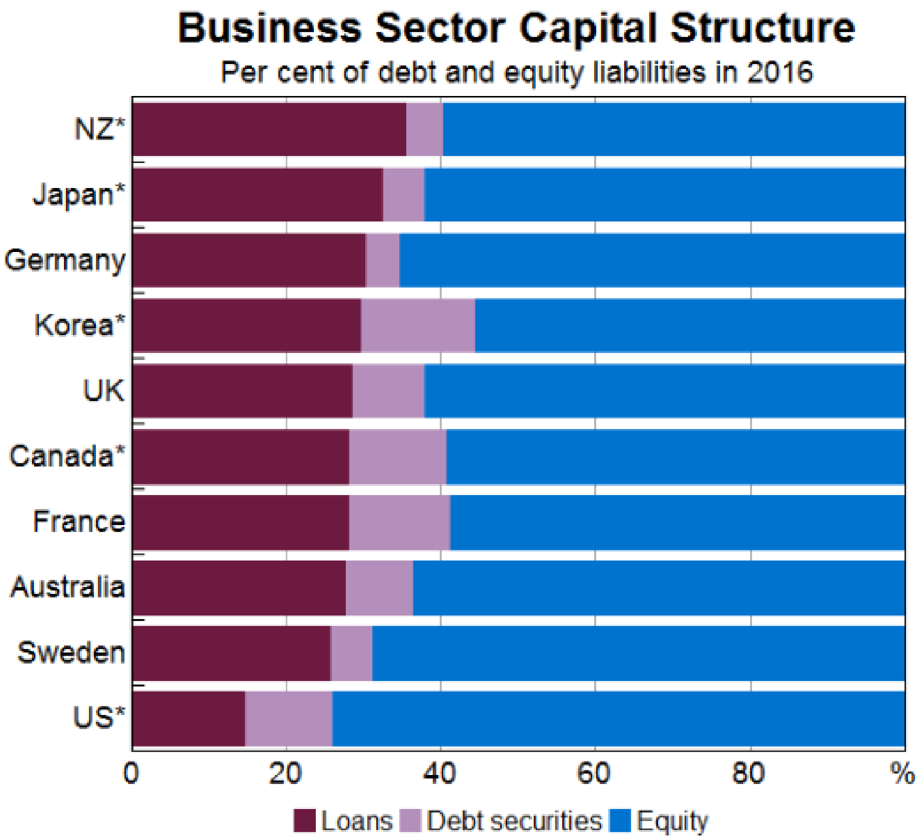
The third issue I'll cover is the potential to improve access to finance for entrepreneurs.

Much of what I have to say today draws on the information from a Small Business Finance Advisory Panel that the Reserve Bank has convened each year for the past 25 years.[1] We've gained a variety of perspectives by talking to entrepreneurs from a range of industries and locations across Australia. It's been an invaluable way to better understand the challenges faced by innovative small businesses.

Business funding and investment

But first, I'll start with some observations about the business sector overall. Data from the Australian Bureau of Statistics on the balance sheet of the Australian business sector shows that businesses are financed by around 60 per cent equity and 40 per cent debt (Graph 1).[2] Business debt is dominated by loans from financial institutions, with debt securities playing a relatively minor role. This capital structure is similar to most other comparable advanced economies. The United States, to which we are often compared, is actually an outlier. Bank loans are a much smaller share of business funding in the US.

Graph 1

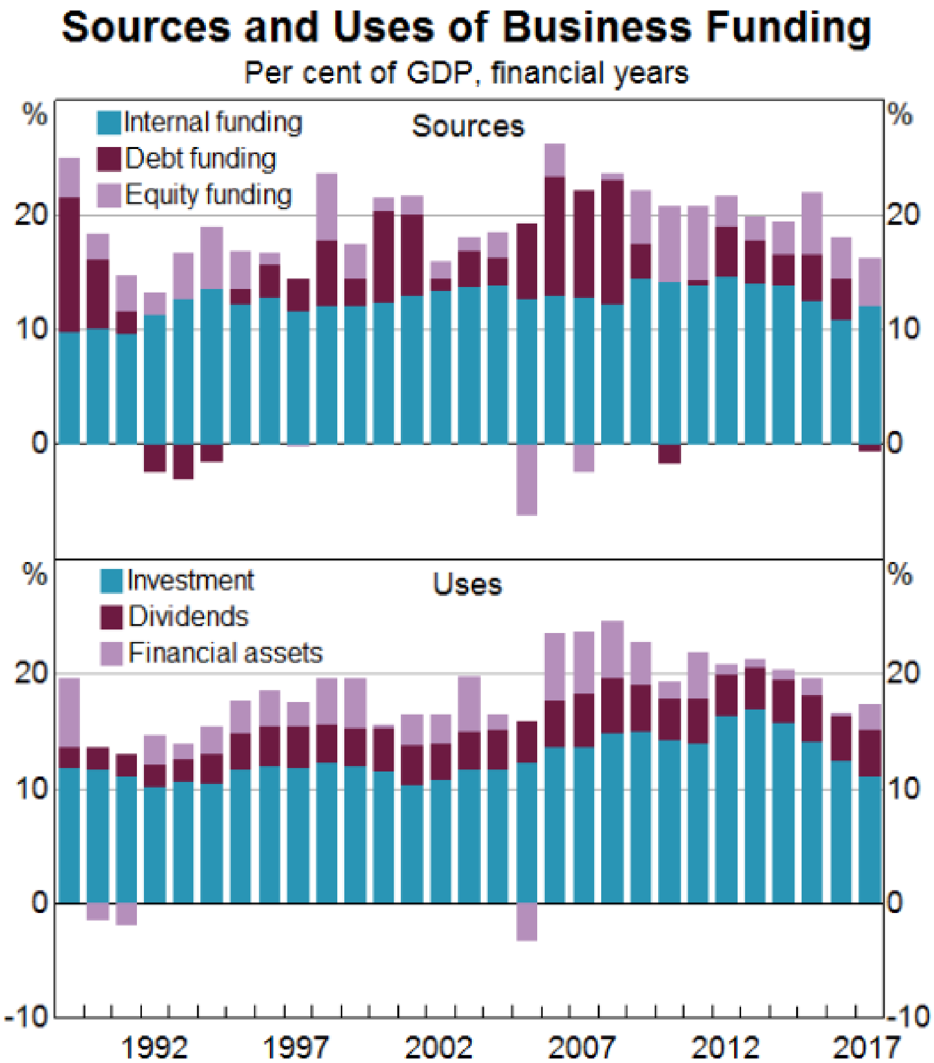


* Business sector liabilities are not consolidated for these countries; 2015 data for Japan and New Zealand

Sources: OECD; RBA

The primary source of new finance for Australian businesses is internal funding (Graph 2). That is supplemented by funds raised externally. The primary use of funds is for productive investment, such as commercial buildings, machinery, software and other forms of intellectual property. A non-trivial share, though, is used to pay dividends and to purchase financial assets, or for mergers and acquisitions.[3]

Graph 2

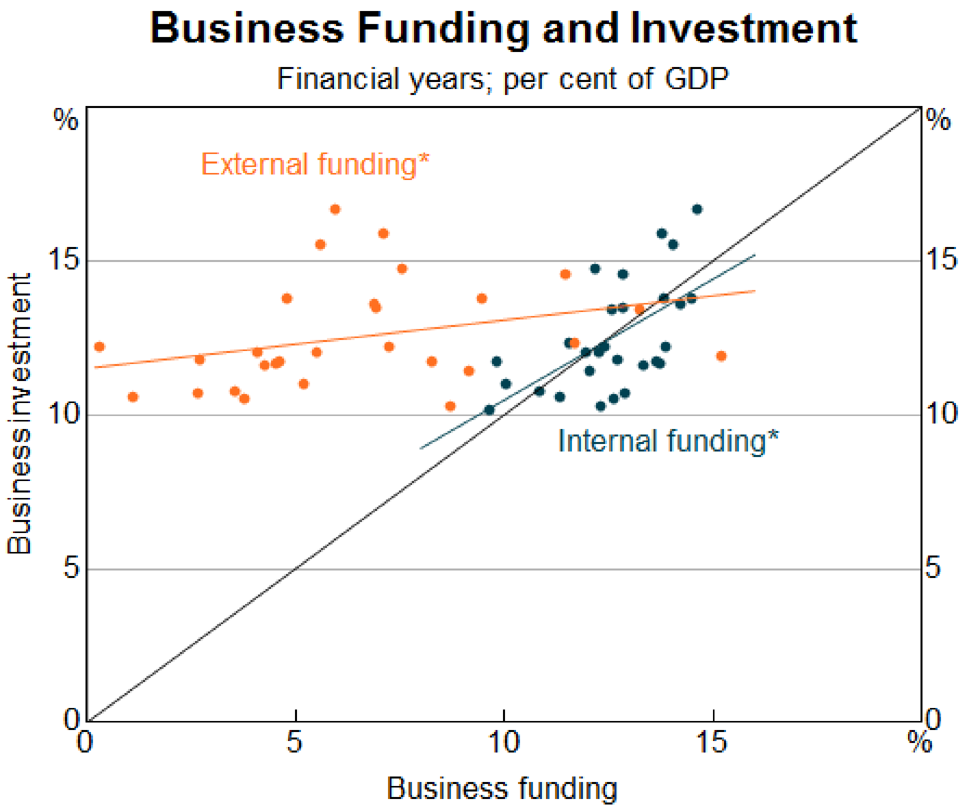


Sources: ABS; RBA

It is well established in the literature that businesses prefer to finance investment using internal funds. Raising funds externally is more costly and can involve restrictions being imposed on the managers.

Internal funding is closely related to business investment. They are similar in size. This is evident in Graph 3, in which the dots comparing the level of internal funding (in a given year) with the level of business investment (the following year) are clustered around the 45 degree line. Also, there is a clear positive relationship between internal funding and investment.[4]

Graph 3



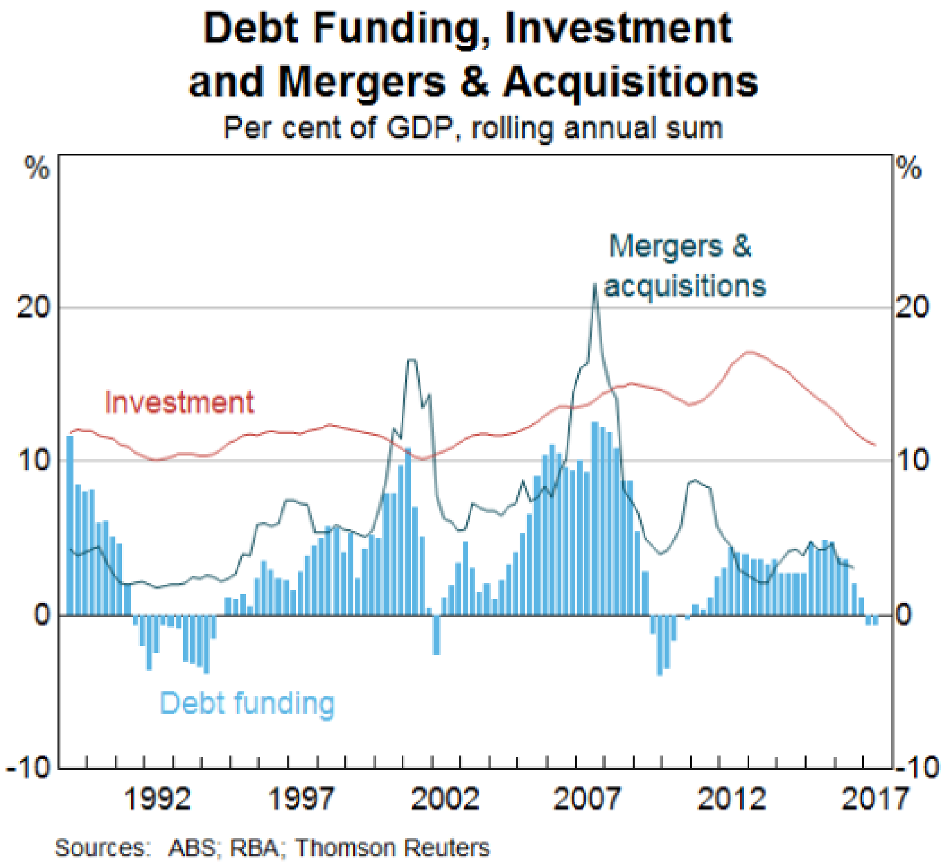
* Internal funding is lagged one year; external funding is not lagged

Sources: ABS; RBA

In contrast, the relationship between external financing and investment is less clear in the aggregate data. External financing is generally much smaller than investment – that is, the external funding dots in Graph 3 tend to be well to the left of the 45 degree line. Moreover, there is only a weak positive relationship between businesses' external funding and investment.[5]

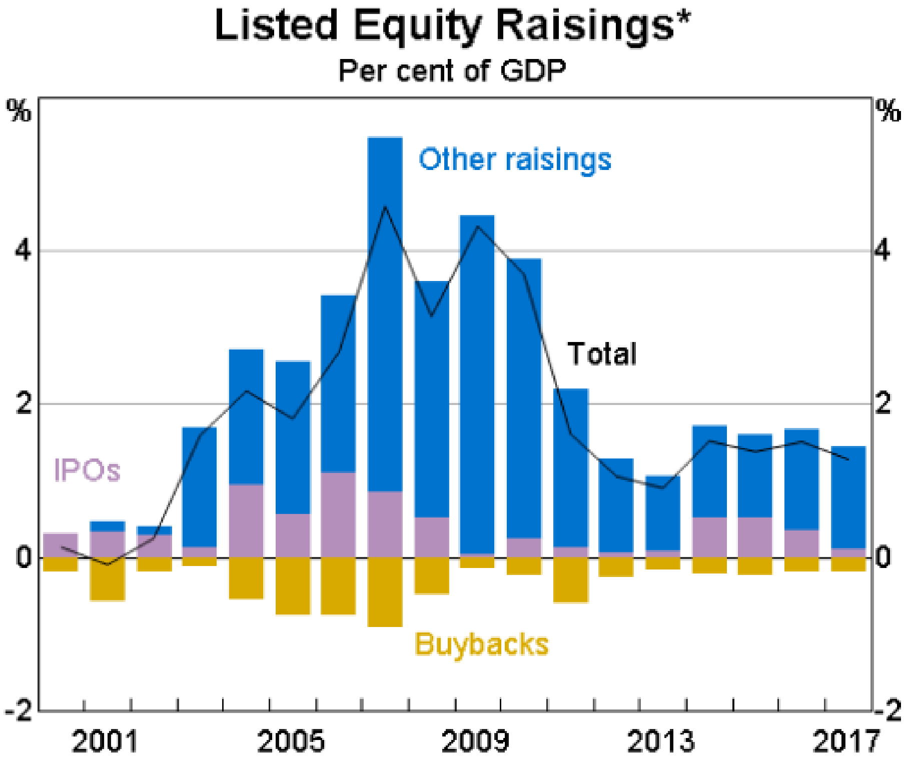
Debt funding has moved more closely with mergers and acquisitions activity (Graph 4).[6] For instance, in the period leading up to the global financial crisis, debt finance was used by a small number of highly leveraged firms to fund several mergers and acquisitions.

Graph 4



Like the growth of external debt, listed equity raisings have been relatively modest over the past 10 years, with relatively little capital raised through initial public offerings (IPOs) (Graph 5). This followed a period of significant equity raisings during the 2000s, partly driven by a number of privatisations through public floats.

Graph 5



* Financial year; excludes financials

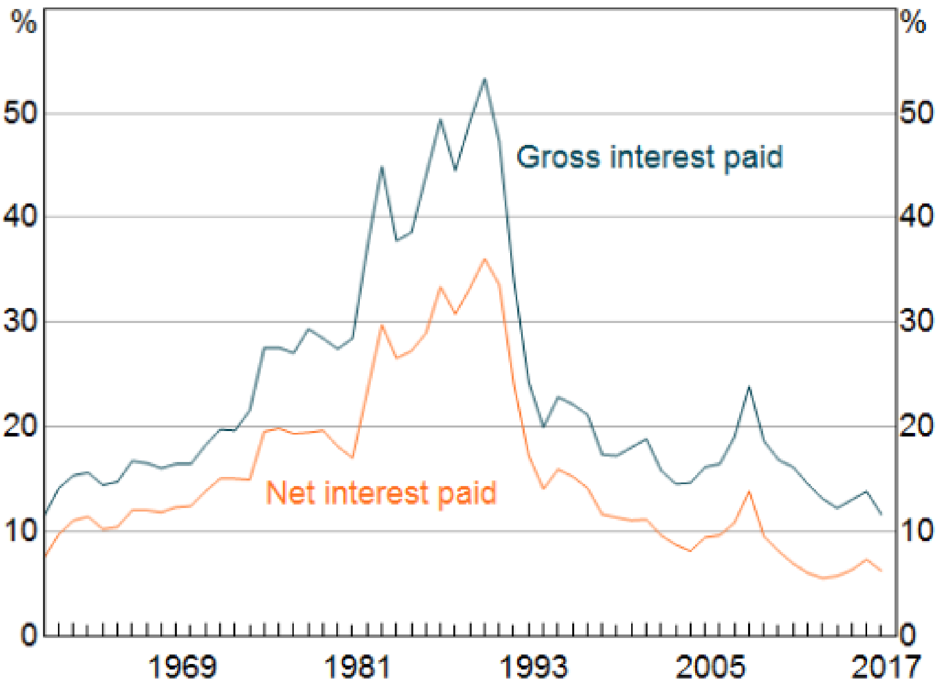
Sources: ASX; RBA

Overall, external finance has become more readily available over recent years. Monetary policy, both here and abroad, is very accommodative, and interest rates on business loans and corporate bonds are near historic lows. Accordingly, the interest being paid by businesses is around its lowest level since the early 1960s (relative to operating profits; Graph 6).[7] Also, equity raising is relatively attractive at current valuations.

Graph 6

Interest Paid by Businesses

Per cent of profits*



* Profits are the gross operating surplus of non-financial corporations

Sources: ABS; RBA

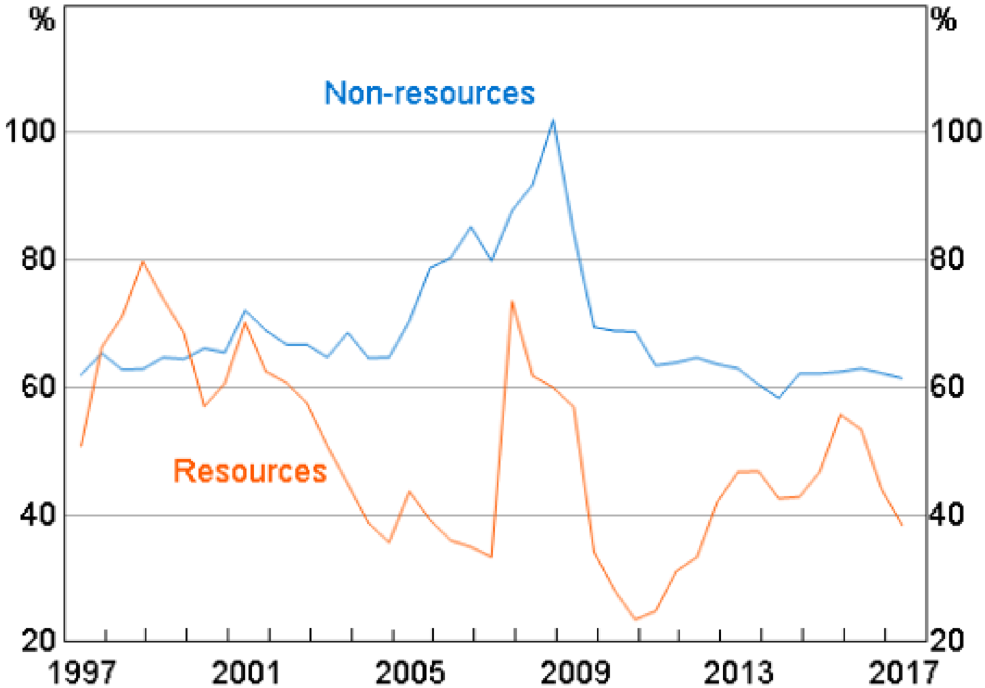
A consistent message from business surveys and the RBA's liaison program has been that funding conditions have generally improved over the past five years.

Despite this, the demand for borrowing by businesses has been relatively moderate. Following the crisis, there was significant deleveraging across the corporate sector (Graph 7). Subsequently, gearing ratios outside the resources sector have remained relatively low. Over recent years, non-mining business investment has been growing and the outlook for investment has improved. However, as I've already noted, firms have been able to finance investment from internal sources. Even in the resources sector, while gearing rose after the global financial crisis, it did not reach the levels that prevailed immediately before the crisis. It has declined in the past couple of years, as resource companies have been using the boost to their cash flows from higher commodity prices and rising output to pay down debt.

Graph 7

Gearing Ratios by Sector*

Listed corporations



* Ratio of book value gross debt to equity; excludes foreign-domiciled companies listed on the ASX

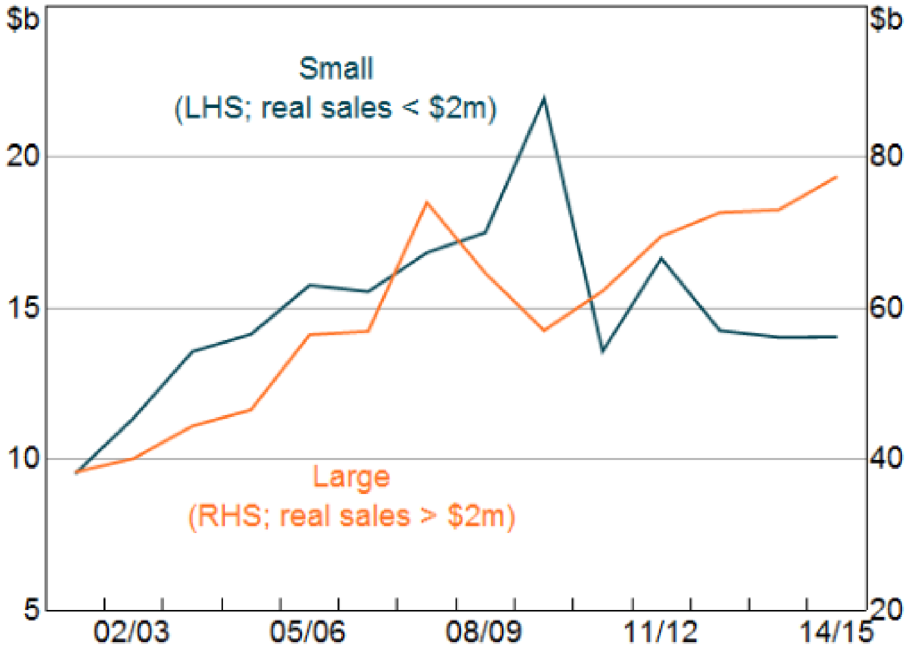
Sources: Bloomberg; Morningstar; RBA

Some parts of the business sector haven't seen the supply of external funding improve over recent years. The domestic banks have sought to constrain their exposures to the resources sector and commercial property, partly in response to prudential supervision from the Australian Prudential Regulation Authority.[8] Also, small businesses continue to find it challenging to obtain external finance. Indeed, this could be one factor that helps to explain why investment by small businesses has been unusually weak over recent years (Graph 8).[9]

Graph 8

Private Non-mining Business Investment

By size



* Sales deflated using division output deflators; capital purchases; excludes agriculture, mining, utilities and finance

Source: ABS

Finance for small businesses

The challenge of obtaining finance has been a consistent theme of the Small Business Finance Advisory Panel. In this context, it is important to distinguish between two types of small businesses. First, there are the many established small businesses that are not expanding. Their needs for external finance are typically modest. Second, there are small businesses that are in the start-up or expansion phase. They are not generating much in the way of internal funding. Accordingly, those businesses have a strong demand for external finance. I'll focus my comments on the issues relevant to this second group of small businesses.

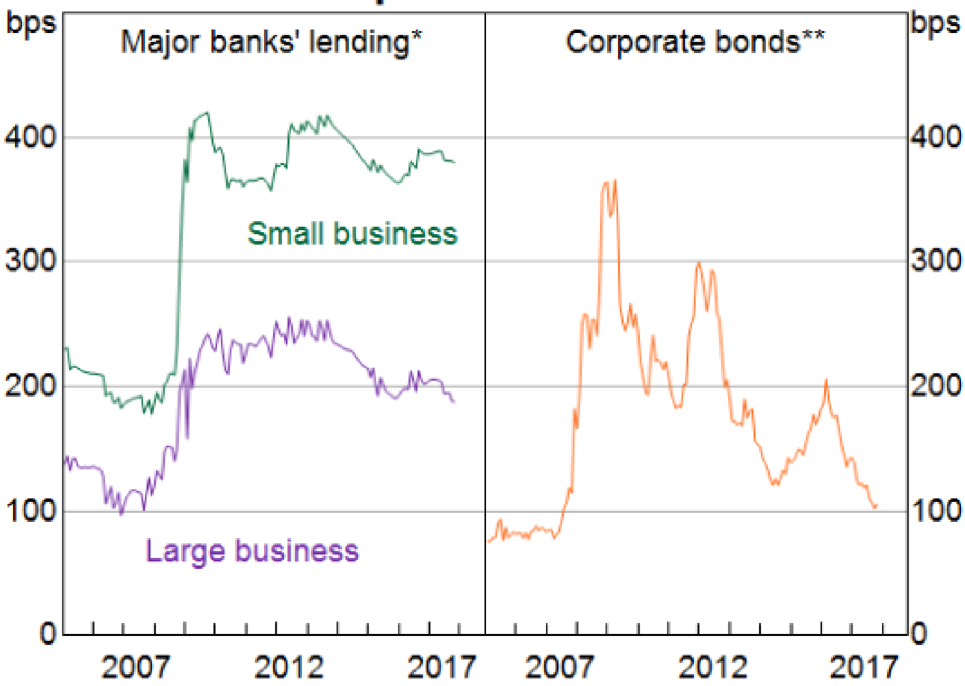
I should emphasise again that access to finance for small businesses is important because they generate employment, drive innovation and boost competition in markets. Indeed, small businesses in Australia employ almost 5 million people, which is nearly half of employment in the (non-financial) business sector. They also account for about one-third of the output of the business sector.[10]

Compared with larger, more established firms, smaller, newer businesses find it difficult to obtain external finance since they are riskier on average and there is less information available to lenders and investors about their prospects. Lenders typically manage these risks by charging higher interest rates than for large business loans, by rejecting a greater proportion of small business credit applications or by providing credit on a relatively restricted basis.

The reduction in the risk appetite of lenders following the global financial crisis appears to have had a more significant and persistent effect on the cost of finance for small business than large business. After the crisis, the average spread of business lending rates to the cash rate widened dramatically. The increase was much larger and more persistent, though, for small business loans (Graph 9). In part, this increase owed to the larger increase in non-performing loans for small businesses than for large business lending portfolios (Graph 10). It’s not clear, however, whether the increase in interest rates being charged on small business loans relative to those charged on large business loans (over the past decade or so) reflects changes in the relative riskiness of the two types of loans.[11]

Graph 9

Interest Rate Spreads on Business Debt



* Rates on outstanding lending; spread to cash rate; small business loans are defined as those below $2 million

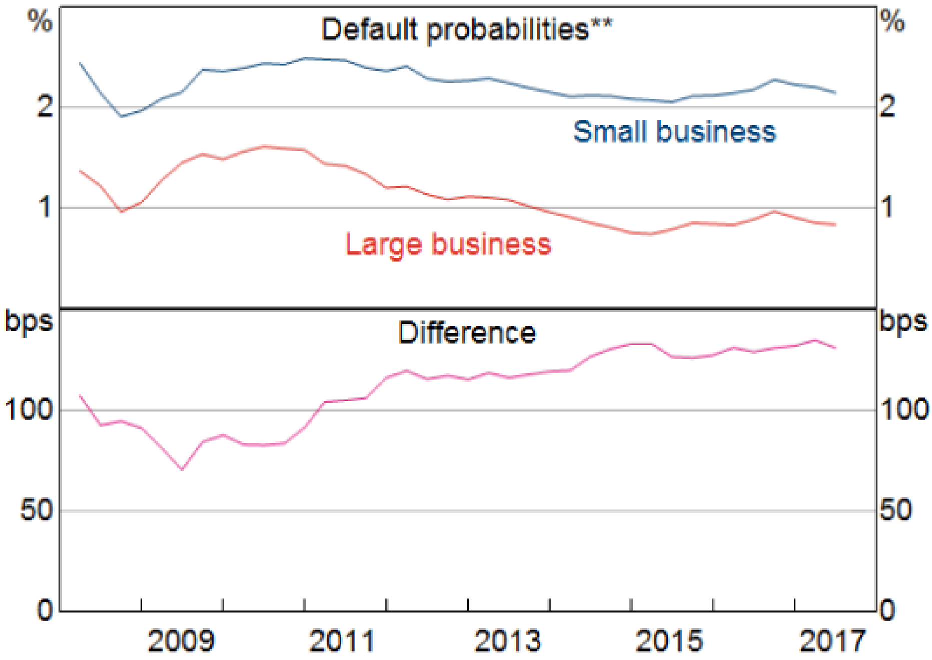
** Five-year secondary market non-resource corporate bond spreads over AGS

Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australian Branch

Graph 10

Business Lending Default Probabilities

Average estimate from internal ratings-based models*



* On-balance sheet exposures of major banks

** 'Small business' is SME retail and SME corporate categories in APRA's capital framework; 'Large' is the corporate category

Sources: APRA; RBA

Over recent years, there has been strong competition for large business lending, which has resulted in a decline in the interest rate spread on large business loans. Part of the competition from banks for large business loans has been driven by an expansion in activity by foreign banks. Large businesses also have access to a wider array of funding sources than small businesses, including corporate bond markets and syndicated lending.

In contrast, competition has been less vigorous for small business lending. Indeed, some providers of small business finance were acquired by other banks or exited the market following the onset of the crisis.[12] Also, the interest rates on small business loans have remained relatively high. This difference in competitive pressures is evident in the share of lending provided to small business by the major banks, which is relatively high at over 80 per cent. This compares with a share of around two-thirds in the case of large businesses. Small businesses continue to use loans from banks for most of their debt funding because it is often difficult and costly for them to raise funds directly from capital markets.

The RBA's liaison has highlighted that if small business borrowers are able to provide housing as collateral, it significantly reduces the cost and increases the availability of debt finance. Lenders have indicated that at least three-quarters of their small business lending is collateralised and they only have a limited appetite for unsecured lending. However, there are a number of reasons why entrepreneurs find it difficult to provide sufficient collateral for business borrowing via home equity:

- they may actually not own a home, or have much equity in their home if they are relatively young;
- similarly, they may not have sufficient spare home equity if they've already borrowed against

their home to establish a business and now want to expand their business;

- and even if they have plenty of spare home equity, using their homes as collateral concentrates the risk they face in the event of the failure of the business.

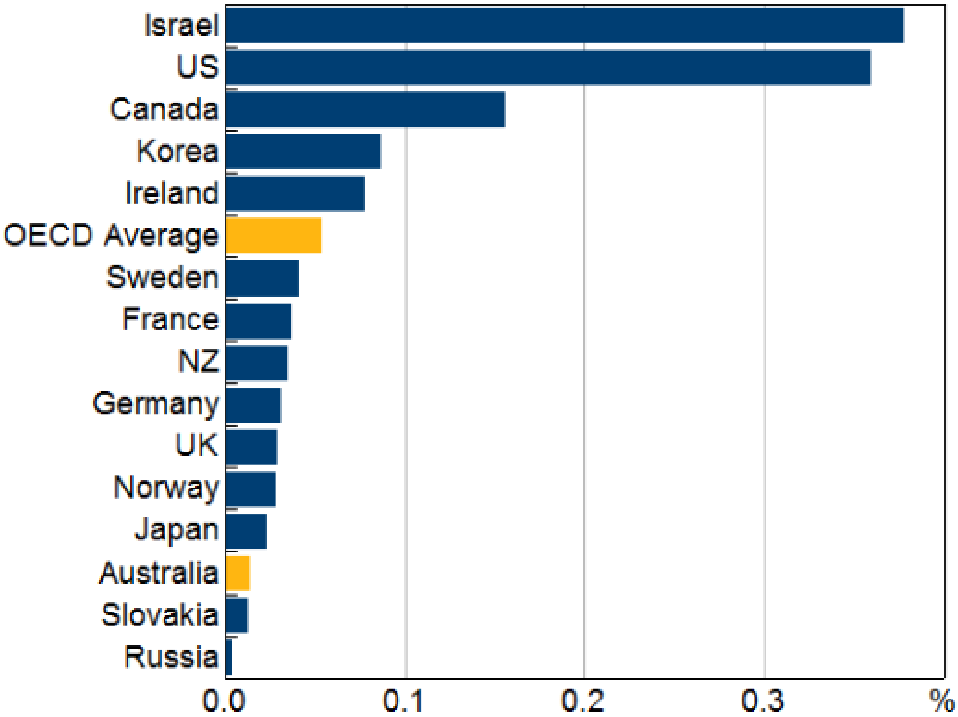
Many entrepreneurs have limited options for providing alternative collateral, since banks are far more likely to accept physical assets (such as buildings or equipment), rather than 'soft' assets, such as software and intellectual property.

Given the higher risk associated with small businesses, particularly start-ups, equity financing would appear to be a viable alternative to traditional bank finance. However, small businesses often find it difficult to access equity financing beyond what is issued to the business by the founders. Small businesses have little access to listed equity markets, and while private equity financing is sometimes available, its supply to small businesses is limited in Australia, particularly when compared with the experience of other countries (Graph 11). Small businesses also report that the cost of equity financing is high, and they are often reluctant to sell equity to professional investors, since this usually involves relinquishing significant control over their business.

Graph 11

Venture Capital Funding*

Share of GDP



* 2016 data or most recent available; venture capital definitions can vary across countries

Sources: OECD Entrepreneurship Financing Database; RBA

Innovations improving access to business finance

There are several innovations that could help to improve access to finance by: providing lenders with more information about the capacity of borrowers to service their debts, and connecting risk-seeking investors with start-up businesses that could offer high returns.

Comprehensive credit reporting

Comprehensive credit reporting will provide more information to lenders about the credit history of potential borrowers. The current standard only makes negative credit information publicly available. When information about credit that has been repaid without problems also becomes available publicly, the cost of assessing credit risks will be reduced and lenders will be able to price risk more accurately; this may enhance competition as the current lender to any particular business will no longer have an informational advantage over other lenders. It may also reduce the need for lenders to seek additional collateral and personal guarantees for small business lending, particularly for established businesses. Indeed, the use of personal guarantees is more widespread in Australia than in countries that have well-established comprehensive credit reporting regimes, such as the United Kingdom and the United States.

For several years, the finance industry has attempted to establish a voluntary comprehensive credit reporting regime in Australia. Participation has so far been limited.[13] However, several of the major banks have committed to contribute their credit data in coming months. The Australian Government has announced that it will legislate for a mandatory regime to come into effect mid next year.

Open banking

The introduction of an open banking regime should make it easier for entrepreneurs to share their banking data (including on transactions accounts) securely with third-party service providers, such as potential lenders. When assessing credit risks, lenders place considerable weight on evidence of the capacity of small business borrowers to service their debts based on their cash flows. For this reason, making this data available via open banking would reduce the cost of assessing credit risk. A review is currently being conducted with a view to introducing legislation to support an open banking regime.

Large technology companies

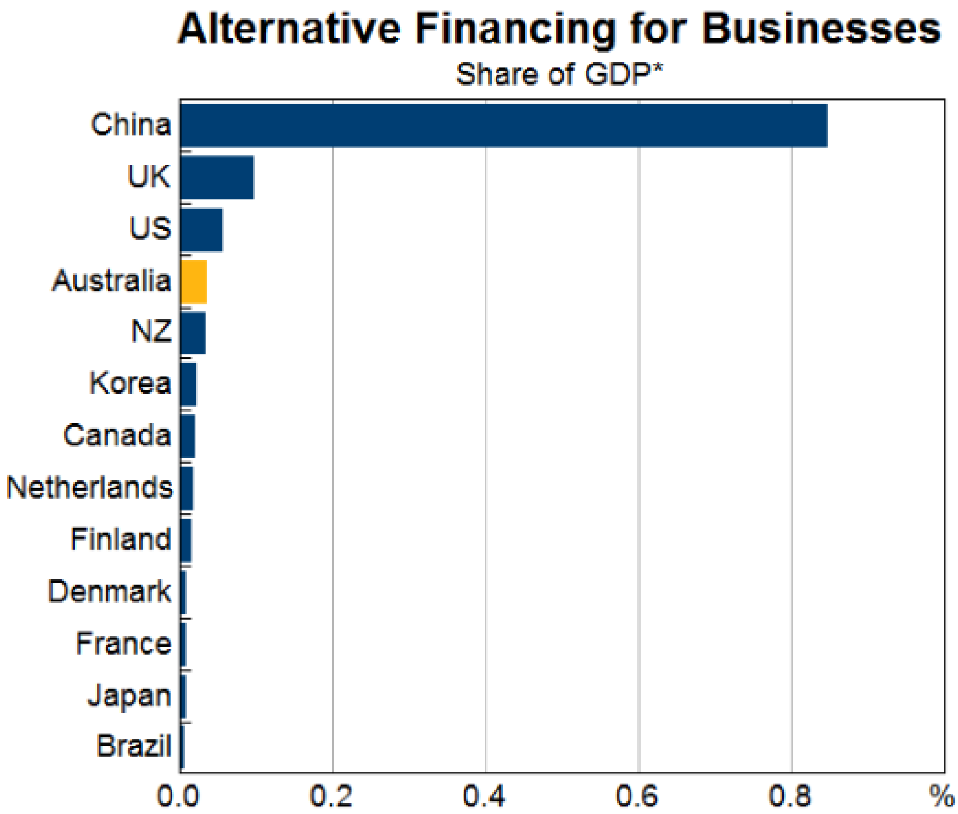
Technology firms can use the transactional data from their platforms to identify creditworthy borrowers, and provide loans and trade credit to these businesses from their own balance sheets. This could supply small innovative businesses that are active on these online platforms with a new source of finance. Amazon and Paypal are providing finance to some businesses that use their platforms. For example, Amazon identifies businesses with good sales histories and offers them finance on an invitation-only basis. Loans are reported to range from US$1 000 to US$750 000 for terms of up to a year at interest rates between 6 and 14 per cent. Repayments are automatically deducted from the proceeds of the borrower’s sales.

Alternative finance platforms

Alternative finance platforms, including marketplace lending and crowdfunding platforms, use new technologies to connect fundraisers directly with funding sources. The aim is to avoid the costs and delays involved in traditional intermediated finance.

While alternative financing platforms are growing rapidly, they are still a very minor source of funding for businesses, including in Australia. The largest alternative finance markets are in China, followed by the United States and the United Kingdom. But even these markets remain small relative to the size of their economies (Graph 12).

Graph 12

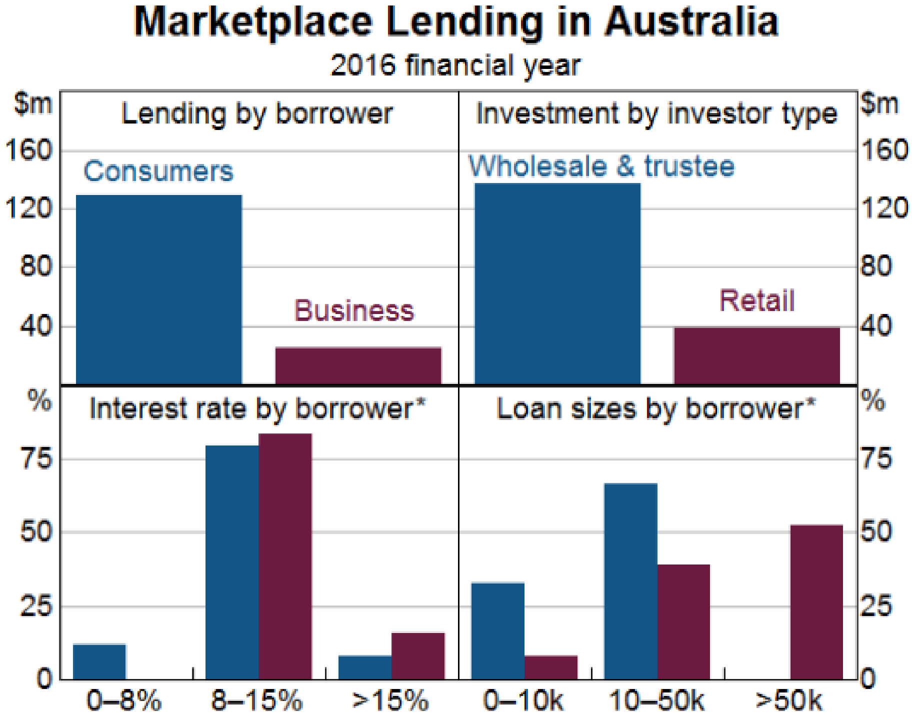


* 2015 data for European countries, 2016 for all others

Sources: Cambridge Centre of Alternative Finance; RBA

Marketplace lending platforms provide debt funding by matching individuals or groups of lenders with borrowers. These platforms typically target personal and small business borrowers with low credit risk by attempting to offer lower cost lending products and more flexible lending conditions than traditional lenders. Data collected by the Australian Securities and Investments Commission indicate that most marketplace lending in Australia is for relatively small loans to consumers at interest rates comparable to personal loans offered by banks (Graph 13).

Graph 13



* Share of loans by value in each bucket

Source: ASIC Marketplace Lending Survey 2017

It is unclear whether marketplace lending platforms are significantly reducing financial constraints for small businesses. Unlike innovations such as comprehensive credit reporting, which have the potential to improve the credit risk assessment process, marketplace lenders do not have an information advantage over traditional lenders. As a result, they need to manage risks with prices and terms in line with traditional lenders.[14] Nevertheless, these platforms could provide some competition to traditional lenders, particularly as a source of unsecured short-term finance, since they process applications quickly and offer rates below those on credit cards.

Crowdfunding platforms have the potential to make financing more accessible for start-up businesses, although their use has been limited to date. Crowdsourced equity funding platforms typically involve a large number of investors taking a small equity stake in a business. As a result, entrepreneurs can receive finance without having to give up as much control as expected by venture capitalists.[15] Several legislative changes have been made to facilitate growth in these markets, including by allowing small unlisted public companies to raise crowdsourced equity.

Conclusion

The provision of external finance to Australian businesses is dominated by the banks. Funding from that source has generally become available on increasingly favourable terms for large borrowers over recent years. Even so, much of business investment is financed from internally generated funds, while growth in business debt is more closely related to mergers and acquisitions activity, which has remained relatively modest compared with levels seen before the global financial crisis.

Entrepreneurs starting or expanding a small business are typically more reliant on external finance, which remains difficult to obtain. Lending to small businesses is dominated by the major banks and, there is less competition in this market. Interest rates paid by small businesses are also much higher than those paid by large businesses; it’s not clear the extent to which this difference reflects the greater risk involved in extending loans to small businesses. Entrepreneurs starting businesses often resort to personal credit cards for day-to-day funding, while those seeking to expand their businesses are concerned by the collateral required to obtain funding at lower interest rates.

There are several innovations that have the potential to improve access to finance, although their use has been limited to date. The most promising development in the near term is mandatory comprehensive credit reporting, which has the potential to lower the cost of credit risk assessment for all lende

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1 The Panel's discussion are a useful input into Bank work, for example Reserve Bank of Australia (2012), 'Small Business Finance Roundtable: Summary of Discussion', RBA Bulletin, June, pp 91–94. Information about the panel can also be found on the RBA website: www.rba.gov.au/about-rba/panels/small-business-finance-advisory-panel.html.

2 The finances of the business sector are challenging to measure, since the boundary between businesses, households and the government is not clearly defined and evolves over time. Unincorporated businesses tend to be closely intertwined with the households that own them and, as a result, it is virtually impossible to separately identify their balance sheets. In addition, the privatisation of many public corporations over recent decades has shifted the responsibility for financing these businesses from the public sector to the private sector. To deal with these challenges, the business sector is defined here to include all private and public corporations.

3 Mergers and acquisitions within the Australian business sector are not captured in the data shown in Graph 2, which is based on net transactions by the Australian business sector with other sectors, including foreigners.

4 A similar positive relationship is observed between internal funding and investment in the same year. However, the correlation is larger between internal funding this year and investment next year, which is consistent with businesses being secure about their finances ahead of committing to sizeable investment outlays. External funding is somewhat positively correlated with investment in the same year and that correlation is a bit stronger than between external funding this year and investment next year. This result makes sense as it would be costly for a business to obtain external funding and then not put that funding to use as quickly as possible.

5 Similarly, relatively timely indicators such as business loan approvals and credit have not been found to be useful for forecasting investment. Previous RBA research has found a significant relationship between investment and variables such as the user cost of capital, cash flow, sales, business confidence and the terms of trade: La Cava G (2005), 'Financial Constraints, the User Cost of Capital and Corporate Investment in Australia', RBA Research Discussion Paper No 2005–12 and Cockerell L and S Pennings (2007), 'Private Business Investment in Australia', RBA Research Discussion Paper No 2007–09.

6 The ABS data on business debt funding, which is a broad measure of loans and debt securities, have been weaker over the past year than RBA business credit, which measures lending by ADIs to businesses. The weaker growth of total debt is likely to reflect companies repurchasing debt securities and reducing offshore borrowing, particularly in the resources sector. The repayment of government loans following the privatisation of some public corporations has also played a role.

7 The decline in interest paid since the late 1980s has been driven entirely by lower interest rates, as the ratio of debt relative to operating profits has increased a little over this period.

8 See Byres W (2017), 'Prudential Perspectives on the Property Market', Remarks at CEDA's 2017 NSW Property Market Outlook Sydney, 28 April. Available at: .

9 See Debelle G (2017), 'Business Investment in Australia', Remarks at UBS Australasia Conference 2017, Sydney, 13 November. The estimates for Graph 8 are sourced from the ABS' BLADE (Business Longitudinal Analytical Data Environment) database. The results of these studies are based, in part, on ABR data supplied by the Registrar to the ABS under A New Tax System (Australian Business Number) Act 1999 and tax data supplied by the ATO to the ABS under the Taxation Administration Act 1953. These 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 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 ABR 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 have been allowed to view data about any particular firm in conducting these analyses. In accordance with the Census and Statistics Act 1905, results have been confidentialised to ensure that they are not likely to enable identification of a particular person or organisation.

10 These shares have been relatively stable over the past decade. These data refer to businesses that employ fewer than 20 people and are sourced from Australian Industry, 2015–16, ABS Cat no. 8155.

11 Note that Graph 10 is based on default probabilities, not expected or actual losses, which will also depend on losses given default. Those, in turn, will depend (among other things) on collateral held against the loans, which in the case of many small business loans is housing.

12 These included, for example, Bankwest, St. George Bank and GE Capital.

13 Productivity Commission (2017), 'Data Availability and Use: Overview & Recommendations', Productivity Commission Inquiry Report No 82, Canberra.

14 A survey by the Federal Reserve Bank of New York found that small businesses were noticeably less satisfied with online lenders than with traditional lenders, with more complaints about the interest rates charged and the repayment terms imposed by online lenders. Federal Reserve (2016), 'Small Business Credit Survey', Report on Employer Firms', April, available at .

15 Some crowdfunding platforms also allow businesses to raise funds through presales of a new product. These platforms offer some advantages to small business, since they receive direct funding from customers, require no collateral, and can provide a gauge of market interest. However, success on these markets is unpredictable, and the sites are geared towards consumer-oriented products.