

# Small Business Finance Roundtable: Summary of Discussion

The Reserve Bank hosted a small business finance roundtable on 22 May 2012. The purpose of the roundtable was to better understand how the small business sector is financed and where there might be information gaps. The attendees included small business owners, sector representatives, financial institutions, academics, data providers and policymakers.<sup>1</sup> While the roundtable focused on the financing of the small business sector, it also considered a number of other issues including the characteristics of small businesses and the challenges facing the sector. The discussion papers presented at the roundtable are listed at the end of this article and can be found on the Bank's website ([www.rba.gov.au](http://www.rba.gov.au)).

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## The Definition of Small Business

A wide range of criteria are used to define small businesses, including legal status, number of employees, revenue and loan size. While there was some overlap in the definitions, they identify quite different groups of small businesses. The number of decision-makers in the business was an alternative criterion put forward by some participants, although little information is currently collected on this basis. Overall, attendees noted that the sheer diversity of the small business sector made the adoption of a single standard definition of limited use. Rather than striving for consistency, definitions should be tailored to the purpose at hand.

## Motivations, Behaviour and Characteristics

Attendees stressed the personal nature of small businesses. There is often little differentiation between the household and the business, with business issues, such as succession planning, becoming household issues and vice-versa.

As a result of these strong links to the household, small businesses do not operate like scaled-down versions of large businesses. The decision-making is

often much more akin to that of a household, with decisions made directly by the owners rather than through formal managerial systems. Goals will also differ, reflecting owners' differing motivations for starting the business and lifestyle choices.

While some small businesses wish to grow, this is not true for many businesses. Instead, a substantial share of small businesses aim for limited or even no growth. For example, many owners want to keep the business at a manageable scale; prefer to remain focused on the actual businesses' activities rather than its administration; are comfortable with only a certain amount of risk; or are happy with a certain lifestyle.

These differing motivations are consistent with small businesses having a greater dispersion of gearing ratios than large businesses. In particular, while many of those that aim to grow use debt, others have little use for debt. The strong links between small businesses and households also accords with the finding that while small businesses tend to have less debt than large businesses, households that own small businesses tend to have higher debt than other households.

<sup>1</sup> The RBA also conducts a regular business liaison program and has hosted an annual small business finance panel since 1993.

## Interactions with Financial Institutions and Government

### Interactions with financial institutions

The personal nature of small businesses is often reflected in their financing arrangements, with financing evolving with the business. Initially, financing is predominantly tied to the owners' personal situation. As the business develops, financing becomes more closely linked to the performance of the business. This progression in financing also reflects the types of finance available to small businesses. As small businesses apply for more advanced forms of funding, more detailed financial plans and statements are required. For those without backgrounds in commerce, such reporting is potentially a real barrier to obtaining finance.

The interaction between small businesses and financial institutions is also influenced by lenders' ability to accurately estimate and price risk. For example, banks are generally not well placed to offer debt funding for some start-up businesses given that the inherent risks require an equity-like investment and return. At the same time, owners may be unwilling to cede the control that such equity-like finance entails, as many are motivated to start a small business in order to have more control.

Participants also discussed ways in which the loan application process could be improved. In particular, there was an appreciation that lenders often had a better idea about the macroeconomy and the outlook for various industries than potential small business borrowers. Consequently, the provision of more information by lenders on why applications were rejected could, for example, allow small business owners to address flaws in their business case. Feedback from lenders to small businesses may also help to prevent firms in new and innovative industries from being grouped inappropriately into existing industries. The general consensus of both borrowers and lenders was that it was unclear how lenders could speed up loan application times given the significant risks for both the lender and borrower.

In particular, participants noted that while lenders' investments in automation have sped up the loan approval process in cases where the decision is obvious, they have had less effect on the time taken for decisions that are less clear-cut. Some small businesses noted that they preferred to be turned down immediately, rather than experiencing a protracted process.

### Price and non-price conditions on intermediated financing

The pricing of finance was not generally viewed as a major impediment to small businesses' activities currently. The fact that small business credit has been little changed for a number of years was instead largely attributed to a lack of demand. To the extent that small businesses had concerns, participants pointed to non-price conditions, such as covenants and disclosure requirements. Of these, business owners were most concerned by covenants. Covenants have been tightened following the onset of the global financial crisis and have not eased markedly. While covenants are used by lenders to lessen the risk of the loan, they can be problematic for high growth firms. A high growth firm might, for example, temporarily reduce its sales activities – suppressing current profits – as it focuses on investments that might boost future sales. In some cases this might lead to breaches in covenants or its lenders having concerns about the credit quality of the business and, in turn, the business having concerns over the stability of its external funding.

Participants also discussed why finance for small business was more expensive than finance for large businesses or individuals, and why it has become more expensive since 2008 both in absolute and relative terms. A number of factors suggest that lending to small business is more risky than other forms of bank lending. In particular, small businesses were more likely to default and created larger losses (for a given sized loan) when default occurred.

Funding cost pressures were the main reason for the rise in the price of small business finance

since the onset of the global financial crisis. Several possible explanations were put forward as to why small business finance had become relatively more expensive than other loans. One was that, pre-2008, insufficient risk had been priced in to small business lending. The relative price rise thus reflects a recognition of the higher level of risk involved in small business lending. Another explanation was that the exit of several lenders post-2008 had lessened competition more in the small business market than in other markets.

Participants noted the practice of small businesses using housing loans rather than business loans, despite the greater levels of risk involved. The lower price (and capital charge from the lenders' perspective), and the smaller administrative burden, were given as reasons for this trend. It remains to be seen, however, how dissimilar the risks of such lending are relative to that of conventional residential mortgage lending over the longer term.

### Government interaction

Some participants suggested that governments should focus on removing impediments to small business activities. One impediment was the fixed costs of regulatory compliance, which may place a higher burden on small businesses than large businesses. Similar concerns were voiced regarding the fixed costs associated with enforcing contracts. These enforcement costs can disadvantage small businesses to the extent that they have fewer resources on which to draw. Mention was also made of the weaker bargaining position of small business in drawing up contracts.

### Outlook for the Sector

A number of medium- and long-term challenges for small businesses were discussed. In the medium term, lower demand and confidence, as well as higher costs, were pointed to as significant challenges. Concerns over the lack of skilled workers were also noted, as small businesses do not have the economies of scale to make formal training affordable. The multi-speed

economy was also discussed. There was agreement that to characterise the economy as 'two-speed' was an oversimplification and that there was a spectrum of performance in the economy. Indeed, it was noted that the divergence between industries and regions is not high by historical standards, though it may grow in the medium to long term.

The increase in house prices relative to income over recent decades, and the ageing of the population, were highlighted as potential challenges over the longer term. On the first point, households' equity in their homes is an important determinant of their access to funding for small business ventures. An increase in house prices relative to income increased previous generations' housing equity, and hence potential access to funding. In contrast, younger generations of potential entrepreneurs are unlikely to benefit from this same process. Further, higher house prices have contributed to younger generations delaying their housing purchases, meaning that they may have less ability to start a small business as they lack the collateral to take out a loan. On the second point, the ageing of the population might slow activity in the small business sector given older individuals tend to have a higher level of risk aversion and are less likely to start new businesses or attempt to expand existing businesses. Several possible responses were suggested by participants, including a rise in venture capital (possibly funded by Australia's superannuation system), more transfers between generations, or a general increase in the cost of business debt as a larger share is extended on an unsecured basis. ✎

### Papers Presented at the Roundtable

**Black S, A Fitzpatrick, R Guttman and S Nicholls (2012)**, 'The Financial Characteristics of Small Businesses', Small Business Finance Roundtable, Sydney, May. Available at <<http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/03-fin-character-small-bus.pdf>>.

**Connolly E, D Norman and T West (2012)**, 'Small Business: An Economic Overview', Small Business Finance Roundtable, Sydney, May. Available at <<http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/01-overview.pdf>>.

**Matić M, A Gorajek and C Stewart (2012)**, 'Small Business Funding in Australia', Small Business Finance Roundtable, Sydney, May. Available at <<http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/02-small-bus-funding-aus.pdf>>.