The Current Climate for Small Business Finance

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Abstract

Economic conditions for small and medium enterprises (SMEs) have been relatively strong since the second half of 2021, and demand for business finance is high. However, the environment remains challenging and uncertain, and interest rates on loans for SMEs are rising from historical lows. Small businesses continue to report that accessing funding through banks is a challenge, although new lenders and products are providing alternative sources of finance. The article considers these recent developments, drawing in particular on the discussions of the Small Business Finance Advisory Panel, which met in July this year.

Introduction

Small businesses' access to finance has been a longstanding focus for the Reserve Bank. Each year, the Bank convenes a Small Business Finance Advisory Panel to better understand the challenges faced by small businesses, with 2022 marking the 30th anniversary of this practice.[1] This year's panel convened in mid-July and focused on economic conditions for small businesses, their appetite to take on debt and the challenges they encounter accessing finance.[2] This article summarises recent developments in small business finance, drawing on the panel's discussions, a range of data and the Bank's ongoing liaison with businesses and lenders.

Economic conditions for small businesses

Economic conditions for small businesses have improved, but the environment remains challenging and uncertain. Small businesses have been disproportionately affected by the COVID-19 pandemic because they are more likely to be in industries that have been affected by restrictions on movement. Indeed, panellists in face-to-face service sectors or tourism saw their orders and revenue fall sharply during lockdown periods. By contrast, businesses that were able to take advantage of online channels – especially those in the IT and software sectors – achieved strong growth throughout the pandemic.

The Australian economy bounced back from the COVID-19 lockdowns in the second half of 2021, and has since maintained strong underlying momentum. In line with this, panellists saw demand for their products and services recover rapidly as containment measures eased and economic activity rebounded. This is consistent with strong growth in retail sales since mid-to-late 2022, especially for small retailers (Graph 1). Current demand was described as being at or above pre-pandemic levels for almost all panellists. Many panel members also stated that strategic shifts in their business models and product lines made during the lockdown periods have had a lasting beneficial impact on their revenue.

Conditions and confidence have eased more recently as a result of above-average increases in input and labour costs, difficulties attracting and retaining workers, ongoing supply constraints and increased uncertainty about the economic outlook (Graph 2). Inflation is high and has picked up by much more than expected over the past year. Panellists noted that rising prices for fuel, freight, packaging and food has affected their margins and profitability. In response to rising input cost and wage pressures, most panellists stated they have passed through higher prices to their customers.

Panellists widely noted that it has been challenging to attract and retain staff given the competitive labour market. Conditions in the labour market are the tightest they have been in a number of decades. The strong demand for labour points to the resilience of the economic recovery and the general strength in aggregate demand; however, it has led to ongoing labour shortages, which have in some cases constrained panellists' ability to invest or increase output. As a result, many panel members have been offering larger-than-usual pay increases, or are about to do so. This was common across most industries but was particularly prevalent for staff with technology skills. These experiences are consistent with signs of rising wages in the economy at large (Graph 3) (Dwyer, McLoughlin and Walker 2022). Matching hours worked by staff to fluctuations in demand also remains challenging for small firms, with panellists noting that consumer behaviour has become less predictable since the pandemic. For example, workers no longer consistently commute to central business districts five days per week. To better meet fluctuations in demand, a couple of panellists noted that they prefer to hire casual workers.

Borrowing costs for SMEs

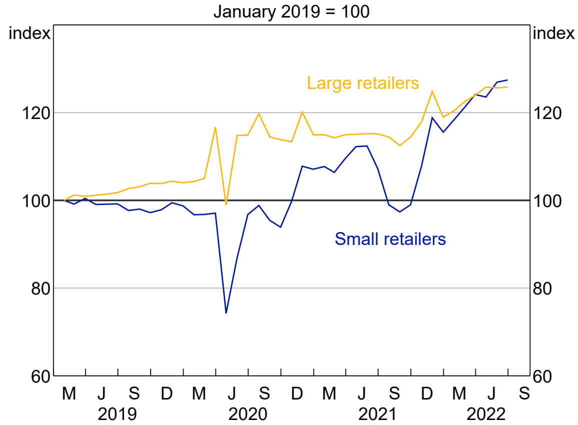
As the economic outlook improved in the second half of 2021 and early 2022, the Reserve Bank Board ended a number of the extraordinary policy measures put in place to support the economy through the pandemic.[3] In addition, the Board started raising the cash rate from May 2022 to normalise monetary conditions.

In response, interest rates on most types of business loans have increased, including on variable-rate loans to SMEs, which account for around three-

Graph 1

Retail Sales Growth by Size

January 2019 = 100

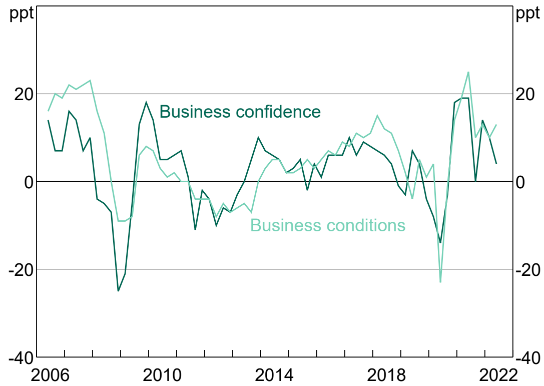


Source: ABS

Graph 2

SME Business Sentiment*

Net balance



* Survey captures businesses with turnover between $2 million and $10 million.

Source: NAB

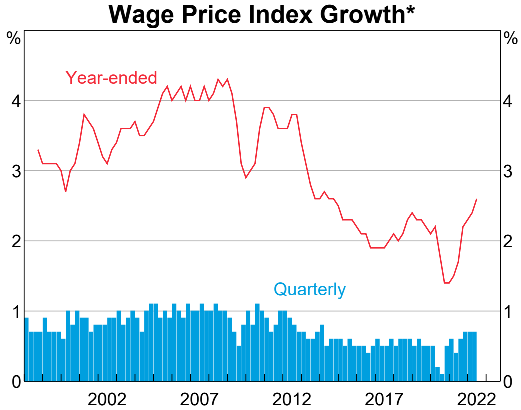
quarters of outstanding SME loans (Graph 4). From October 2021 into early 2022, this reflected the impact of rising market-based interest rates as expectations for monetary policy tightening increased. Average interest rates on new fixed-rate loans for SMEs have increased sharply since the start of the year. Since May, lenders have passed through the cash rate increases to their published small business indicator rates (the pricing benchmark for many small business variable-rate products). As a result, average interest rates on variable-rate loans have also increased.

In general, smaller businesses face higher borrowing costs than larger businesses as they are typically more risky (Graph 5). Modelling by the major banks suggests that SMEs are around twice as likely to default on their loans as standard mortgage customers and large corporations (Graph 6). The spread between interest rates on loans for smaller businesses and those for larger businesses increased slightly in 2020, but subsequently narrowed and is now well below pre-pandemic levels. This decline reflects the fact that large business lending rates increased ahead of SME lending rates, due to the sharp rise since the start of the year in the three-month bank bill swap rate, which large business lending rates are typically linked to. The average rate on total outstanding SME loans began to pick up from May alongside increases in the actual cash rate as lenders passed these through to variable-rate SME loans.

Despite the narrowing in this spread between small and large business lending rates, recent increases in lending rates could have a larger impact on SMEs'

Graph 3

Wage Price Index Growth*



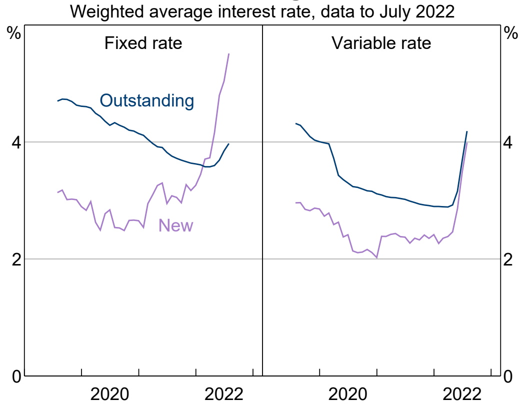
* Total hourly rates of pay excluding bonuses and commissions.

Source: ABS

Graph 4

SME Lending Rates

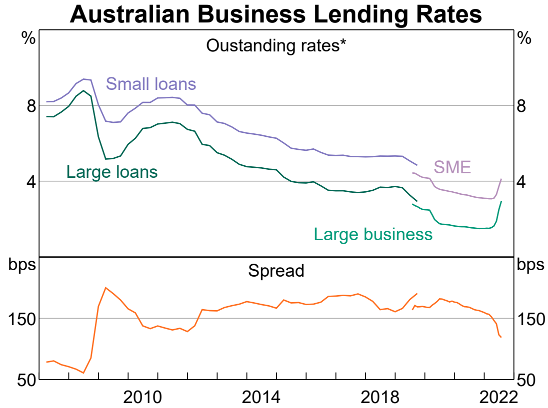
Weighted average interest rate, data to July 2022



Sources: APRA; RBA

Graph 5

Australian Business Lending Rates



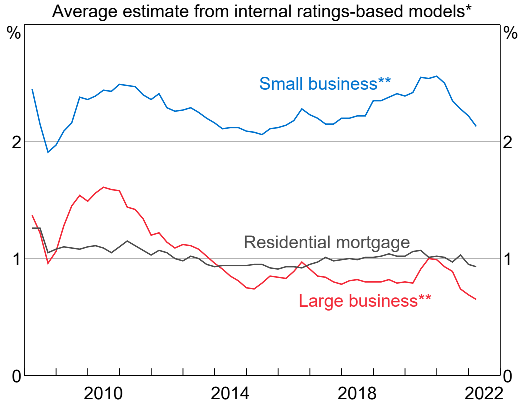
* Small loans data up to June 2019 reflect loans valued less than $2 million; large loans data up to June 2019 reflect loans valued $2 million or more; from July 2019 new data are used from the Economics and Financial Statistics (EFS) collection (see Statistical Table F7).

Sources: APRA; RBA

Graph 6

Business Lending Default Probabilities

Average estimate from internal ratings-based models*



* On-balance sheet exposures of major banks.

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

Sources: APRA; RBA

overall cost of finance compared to large businesses. Small businesses are generally more reliant on bank loans given that they have fewer alternative sources of funding. Additionally, SME business owners historically prefer debt over equity finance to maintain control of their business (Productivity Commission 2021). By contrast, large businesses can access finance through a range of alternative channels, including by issuing corporate bonds or equity, or by securing a syndicated loan.

As in previous years, many panellists reiterated that the price of lending has generally not been an impediment to accessing finance. Rather, as discussed below, accessing suitable amounts of finance through traditional lenders remains challenging for small businesses, with difficult approval processes and substantial collateral requirements.

Demand for finance

Lending to SMEs increased by around 6 per cent over the past year. This has reflected increased lending to medium-sized businesses; lending to small businesses has been little changed for some time (Graph 7). Lending to SMEs has increased for most industries, with the strongest growth in the construction, goods production and business services industries (Graph 8).

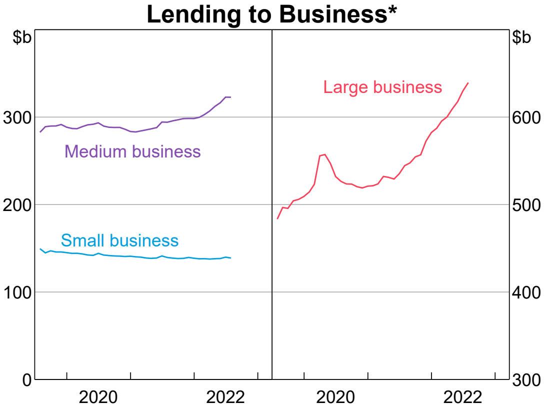
Businesses' demand for finance generally remains high and overall loan commitments are elevated; however, views on future demand are mixed. Some banks expect lending growth to remain strong over the year, driven by medium and large businesses. Lending will continue to be supported by strong economic conditions, the high levels of merger and acquisition activity over the past 12 months, drawdowns on existing credit facilities for working capital requirements and growth in business investment. Other banks have noted that economic uncertainty, rising input costs and climbing interest rates may contribute to some slowing in demand for debt, particularly for small businesses.

Among the panellists, some stated that they are accessing or are considering accessing finance to support growth and significant changes to their businesses, particularly to meet increased demand. Other panellists are hesitant to take on new debt. Additionally, perceived challenges in accessing finance continue to weigh on their demand for debt.

A range of temporary government support measures – such as JobKeeper, Boosting Cash Flow for Employers and the accelerated depreciation schemes – supported businesses' cash flows during the pandemic. These, along with improved business operating conditions, enabled many businesses to build and maintain cash buffers over the past two years, reducing the need for some businesses to take on new debt (Graph 9). Up until the end of June 2022, lending to some SMEs was also supported by the Australian Government's SME loan guarantee schemes, although take-up of the schemes was modest (Treasury 2021; Bank and Lewis 2021). Some panel members noted difficulties

Graph 7

Lending to Business*

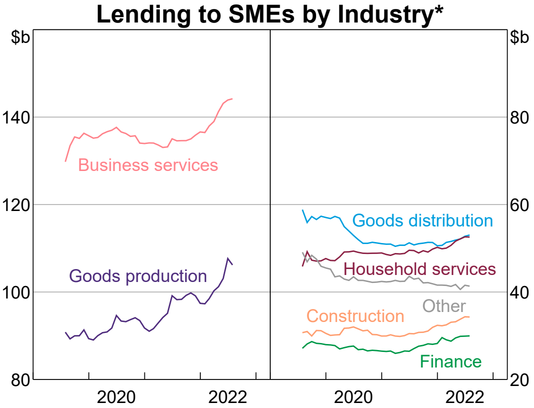


* Data cover financial institutions with $2 billion or more of business credit; not seasonally adjusted.

Sources: APRA; RBA

Graph 8

Lending to SMEs by Industry*



* Excludes lending to ADIs, registered financial corporations and central borrowing authorities.

Sources: APRA; RBA

accessing loans under these schemes; by contrast, many panel members had accessed JobKeeper. A handful of ongoing government programs remain in place to support lending to small businesses, such as the Australian Business Securitisation Fund and the Australian Business Growth Fund (Bank and Lewis 2021; Treasury 2020).

Access to credit from banks

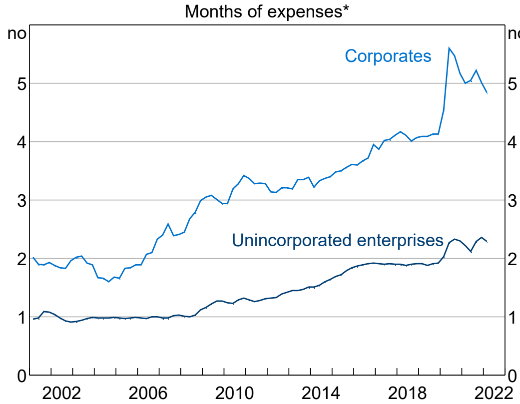
As in previous years, panellists reported that they find it difficult to access finance through traditional lenders with terms that suit their needs. The requirement to provide personal collateral – often residential property – against a business loan continues to be the key constraint on access to finance for some SMEs. SMEs that can provide residential property as collateral are typically able to receive lower interest rates and can secure larger loans than otherwise, although these loans may still not be sufficient to meet the needs of an expanding business (Graph 10). However, some small business owners are unwilling to provide residential property as collateral given the stress involved in such a decision. Doing so could adversely affect the growth of the business, as business owners would become too risk averse with their family home on the line.

Small businesses often face a number of other non-price barriers to accessing financing, arising from their smaller scale, lack of business history (at least in the earlier phases of their business) and less diversified nature. The approval process is often difficult, and can be relatively costly for small businesses that do not have access to the finance teams of larger businesses. As a result, some small businesses on the panel reported that they had given up on seeking finance from banks. First Nations business owners often face even greater financing challenges than other small businesses. First Nations people tend to be younger and have lower incomes, personal and family wealth and educational qualifications on average compared to other Australians (Evans and Polidano 2022).

To reduce non-price barriers to accessing finance, a number of traditional lenders are increasingly automating processes for small business lending. Further, liaison indicates that some banks are implementing digital lending platforms to simplify the application process and reduce processing times for small business customers. These sorts of platforms generally utilise customer data, such as historical transactional and accounting data, to automate credit decisions up to a certain amount (typically up to around $200,000). The Australian Government's Consumer Data Right program is expected to facilitate this shift, as businesses will be able to share financial data with accredited third parties (Australian Government 2022a). By opting in to share data, businesses will be able to better compare products and services between organisations, and will potentially be able to reduce the time it takes to apply and be approved for a loan.

Graph 9

Cash Holdings of Non-Financial Businesses

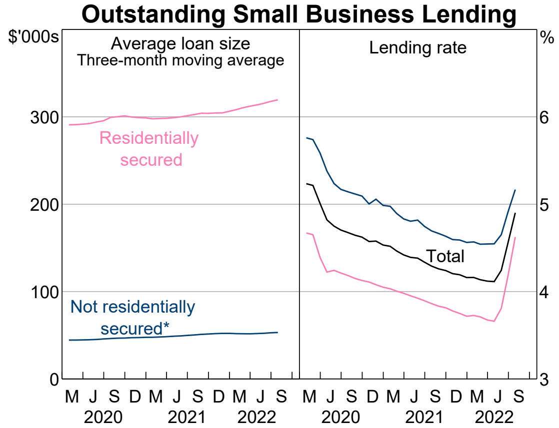


* Expenses estimated from the ABS Quarterly Business Indicators Survey.

Sources: ABS; RBA

Graph 10

Outstanding Small Business Lending



* Excluding credit cards.

Sources: APRA; RBA

Reductions to the Australian Prudential Regulation Authority's capital requirements for banks' SME loans, which will become effective from January 2023, may also support lending to SMEs by lowering the risk weights on loans to SMEs when calculating the necessary capital buffers banks need to maintain, and raising the threshold for defining a retail SME from a loan size of $1 million to $1.5 million.

New lenders and other sources of finance

The emergence of new lenders has helped to improve SMEs' access to finance (Productivity Commission 2021). These new lenders have different risk appetites and approaches to lending beyond traditional loans secured by property. Many panellists reported turning to non-traditional sources of finance over the past year, such as private equity and non-bank finance.

Equity

Small businesses typically have access to a narrower pool of equity funding than larger companies. Australian private companies can only raise equity from professional and sophisticated investors (such as angel investors or venture capitalists), through small-scale personal offers or crowd-sourced equity funding.

Several panellists reported that they had sought private equity in recent years, noting it was more accessible than traditional financing – particularly for high-growth businesses that had yet to turn a profit – but more expensive. This aligns with reports from industry surveys that venture capital and private equity funding was resilient through the pandemic and had been elevated over much of the past year (Preqin and Australian Investment Council 2022). As in previous years, some small businesses noted that private equity can also provide strategic benefits beyond financing, such as expertise and support from larger businesses or experienced investors.

However, recent commentary suggests that activity in venture capital and private equity markets has eased, particularly funding from offshore investors. This trend may be exacerbated by the recent decline in technology company valuations, particularly in the United States. Several panellists confirmed these messages, with the recent declines in valuations relevant for domestic private equity expectations.

Non-traditional finance

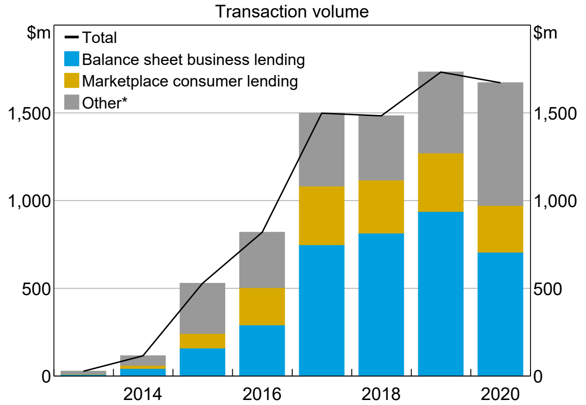
Consistent with global trends, Australia's non-traditional finance market has continued to grow in recent years (Graph 11). Balance-sheet lending by technology firms is the largest source of non-traditional finance. These firms use transaction data to identify creditworthy business borrowers and provide loans and trade credit from their own balance sheets. This makes the application process quicker and easier than that of traditional lenders and these technology firms do not usually require collateral. However, interest rates on these loans tend to be much higher than on bank loans. Additionally, small businesses can typically only access small loan amounts through these lenders (generally up to $250,000), which is a limitation of this source of funding.

Other forms of non-traditional finance have also grown in recent years. Notably, crowd-sourced equity funding – which allows SMEs to raise funds through issuing shares to the public – grew strongly in 2021. While crowd-sourced equity funding can be expensive, some panellists noted that it can help build momentum, brand awareness and customer engagement with a business.

Graph 11

Australian Non-traditional Finance

Transaction volume



* Includes balance sheet consumer lending, marketplace business lending, property lending, invoice trading, crowdfunding and other models.

Sources: Cambridge Centre for Alternative Finance; RBA

Trade credit is another alternative source of business finance. This is an agreement in which a supplier allows a business to delay payment for goods and services already delivered. On the one hand, trade credit is an important source of short-term funding for unlisted (typically smaller) businesses, which allows them to manage short-term cash flows. On the other hand, late payments by larger businesses and long payment terms have often been cited as an issue for smaller businesses. Late payment times remain high for many small businesses, and the latest payment times report register shows the average standard payment time for small businesses is greater than 33 days (Australian Government 2022b). Nevertheless, payment times have broadly been improving over the past year, and the compulsory Payment Times Reporting Scheme – which requires larger corporations to publicly report how quickly they pay invoices issued by small businesses – should help to improve payment times through increased transparency and greater scrutiny.

Conclusion

Small businesses form an integral part of the Australian economy, so understanding their unique challenges is a longstanding focus of the Reserve Bank. Economic conditions for small businesses have improved since the second half of 2021, although more recently cost pressures are increasing and businesses are finding it harder to attract workers. Demand for business finance remains high, but interest rates on business loans are rising from historic lows and views on future demand are mixed. Obtaining finance through banks remains a challenge for small businesses – this has been a consistent theme from the Bank's Small Business Finance Advisory Panel over its three-decade history – but new lenders and products are providing alternative sources of finance.

Endnotes

[*] The authors are from Domestic Markets Department.

[1] The 2022 panel comprised eight entrepreneurs covering New South Wales, Victoria, the ACT, Western Australia and South Australia as well as multiple industries (manufacturing, hospitality, retail, IT and household services), including one First Nations member.

[2] In the Australian Prudential Regulation Authority's lending data, a business is classified as small or medium if it has an annual turnover of less than $50 million. Within this, a business is considered small if it has an exposure to the reporting lending entity of less than $1 million. In the Australian Bureau of Statistics' economic data, a small business is defined as having fewer than 20 employees and a large business has 200 or more employees.

[3] For a summary of these measures, see Debelle (2021).

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