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Narrow Road Capital - Submission on the Financial System Inquiry Final Report

Introduction

Narrow Road Capital is pleased to be able to make a submission to the Federal Government (the Government) on the final report of the Financial System Inquiry (the Inquiry). Narrow Road Capital is an Australian fund manager specialising in Australian high yield and distressed debt. It is therefore well placed to make a submission on issues relating to credit and lending activities. This submission goes beyond the limited interests of Narrow Road Capital as a small business providing investment advice, focussing instead on what is best for ordinary consumers, taxpayers and the Australian economy as a whole.

This submission has responded to selected areas with summarised answers. There is much more that can be added to the discussion on these issues, but this is best done in a face to face setting where questions and views can be fed back and forth. In evaluating the submissions to the final report, the Government should consider organising group discussions that bring together opposing views, moderated by members of the Government. Such discussions could yield new solutions and consensus outcomes, or at least clarify the opposing views for the Government to make judgement on. Narrow Road Capital is willing to participate in any form of feedback that the Government would like to use.

The primary issue covered in this submission is bank stability and supervision. The financial crisis showed the enormous impact that poor quality lending by banks can have on an economy in two main ways. Firstly, poor quality lending by banks can have a catastrophic impact by causing bank failures resulting in costly government bailouts.

Secondly, poor quality lending amplifies the boom and bust of business cycles when credit is initially easily available then subsequently becomes highly restricted. Australia had a much shallower downturn in the financial crisis relative to many other developed nations as it did not have as much poor quality lending in the years preceding the crisis. However, **the experience of the early 1990's and the losses incurred by BankWest, BoQ, BOSI, RBS and Suncorp in recent years serve as a warning that banks in Australia can make the same errors as their international peers.** There is no room for complacency when dealing with the highly leveraged business model that banks operate with.

This submission also touches on:

- Superannuation fee levels and portability;
- Credit card surcharges;
- Financial advice and planning;
- Funding of key financial regulators; and
- Insolvency and external administration.

Two additional topics on taxation and small business lending have been included that were touched on in the appendices of the final report. The tax incentives and disincentives legislated by state and federal governments have a major impact on investment allocations and are the elephant in the room for many financial system issues. Without addressing the tax system Australia will continue to have:

(1) Severe housing affordability problems;
(2) underinvestment in safer assets (debt securities) relative to riskier assets (property and equity); and
(3) a banking system with an unnecessary and excessive dependence on international funding.

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Recommendation 1: Bank Capital Levels

The Inquiry was right to recommend that bank capital levels should be unquestionably strong. The Inquiry was also right to argue for Australian banks to have higher than average levels of capital for its banks. However, the Inquiry failed to be specific on the minimum capital levels that banks should have, preferring instead to defer to global regulators in setting these levels. The Government should be explicit and transparent in forcing Australian banks (either via legislation or through actions carried out by APRA) to hold materially higher levels of capital. The Government should ignore the exaggerated and self-interested campaign of the major banks arguing that the cost of lending will rise substantially if capital levels are meaningfully increased.

Banks that hold more capital, all things being equal, are less likely to require a taxpayer bailout or to default on their obligations to senior creditors. Forcing banks to hold more capital will come at a cost to someone, which could be (i) a 1-2% lower return on equity for bank shareholders, (ii) a 0.05-0.15% per annum higher interest rate for borrowers, or (iii) a blend of both of the aforementioned costs.

As the examples of Japan, Iceland & Ireland have demonstrated, the cost of bank failures on society is enormous and may take decades to be worked through. Bailout costs are rarely fully recovered. The cost of minimising this risk via higher levels of bank capital is comparatively small and is a cost that would be borne by those who benefit from the system the most, bank shareholders and/or borrowers.

Banks operating in Australia should therefore be required to hold more capital. This can be achieved at very low cost by increasing the amount of subordinated debt and preference shares issued, rather than insisting that substantially more ordinary equity is raised. Since the introduction of Basel III conversion to equity terms, subordinated debt and preference shares are a strong form of loss absorption. In the event the solvency of a bank is in question, APRA can force exchange of the subordinated securities into equity, force them to be written off or block the securities from being redeemed until solvency issues are rectified.

Recommendations

Banks should be required to satisfy three minimum capital levels:

- 4% core tier one capital (ordinary equity) to total assets,
- 6% total tier one capital (ordinary equity + preference shares) to total assets, and
- 8% total capital (ordinary equity + preference shares + subordinated debt) to total assets
- These ratios are expressed relative to total assets as this is believed to be a stronger test than risk weighted assets (RWA). However, if RWA is substituted levels of 8%, 12% and 16% should apply.

The table below compares the current average capital level of the four major banks (capital type/total assets) with the proposed minimum capital levels. A buffer relative to the recommended minimum capital levels is included to reflect that prudent banks hold more than the minimum capital levels prescribed by regulators. It shows an increase of 0.084% or 8.4 basis points on the average cost of capital for the four major banks.

Capital Type	Current Market Cost of Capital	Average Major Bank Capital Level	Weighted Average Cost of Capital	Alternative Capital Level	Weighted Average Cost of Capital
Senior	2.60%	94.44%	2.455%	91.60%	2.382%
Subordinated	4.35%	0.67%	0.029%	2.10%	0.091%
Preference	6.35%	0.83%	0.053%	2.10%	0.133%
Equity	11.00%	4.06%	0.447%	4.20%	0.462%
Total	N/A	100.00%	2.984%	100.00%	3.068%

Given the explicit guarantee of retail deposits and the implicit guarantee of other senior creditors, the Government is entitled to insist that the risk of failure is minimised and capital levels are increased. The substantial funding gap that makes Australian banks reliant upon overseas funding is another systemic risk that demands Australian banks have higher capital levels than international peers. Elevated house prices also pose a risk to the Australian banking system and an increase in the countercyclical capital buffers should be considered. **These proposed ratios will not make any bank bulletproof but will substantially lower the risk of a bank failing with minimal impact on the cost or availability of credit.**

Recommendation 2: Mortgage Risk Weights

The ability of the four major banks to use the Basel III rules to lower their risk weighted assets (RWA), in addition to their lower funding costs has resulted in an uneven playing field relative to smaller banks and non-banks. The Basel III rules wrongly imply that residential lending of major banks is less risky than other lenders, simply because they have more complex risk models.

The Basel III system for calculating the RWA of residential lending has resulted in some of four major Australian banks holding less than 1.60% total capital against residential loans. As there has not been a substantial downturn in Australian residential property for over 20 years the data relied upon to create the calculations that underpin this is highly likely to underestimate the future risk of losses.

Recommendations

An alternative three tier system is proposed for the minimum weighting of residential lending relative to RWA:

- 25% for uninsured loans below 70% loan to value ratio (“LVR”) and insured loans below 75% LVR
- 50% for uninsured loans of 70-80% LVR and insured loans of 75-85% LVR
- 100% for all other loans

Applying these minimums to all ADI lenders will partly correct the capital weighting imbalances that the four major banks benefit from, but will not change the cost of funding differential with non-major bank lenders. **The Government should consider instructing APRA to immediately finalise its securitisation & master trust position as a way of reducing the cost of funding advantages that major banks enjoy.** APRA has needlessly procrastinated on these reforms and is now over a decade behind its global peers in this regard. These reforms will allow regional banks and credit unions to attract a great amount of long dated funding via securitisation. It also comes with the added benefit of shifting some of the risk off-balance sheet, which reduces the amount of retail deposits insured by the Government.

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Recommendation 3: Resolution Framework

It is almost inevitable that a bank failure will occur in Australia at some point in the future. A single, small failure does not necessarily indicate a breakdown in prudential oversight or pose systemic risk. It is most important that the process for dealing with a failing bank is known in advance by senior creditors, subordinated creditors/shareholders, APRA and the Government. The question of bailing in senior creditors/implicit guarantees is unresolved.

APRA should take note of the US case where a group of hedge funds is suing the US government over the way the conservatorship of Fannie Mae and Freddie Mac has been dealt with. Litigation is also underway for the Banco Espirito Santo restructure. These cases serve as a warning on what can happen when policy is developed on the run and markets are left trading on uncertain regulatory and government outcomes. **The current period of relative stability in Australia is an opportune time to warn all parties in advance of the process that will apply for an ADI that exhibits solvency issues.**

Recommendations

The process for dealing with an ADI that exhibits solvency issues should be:

- In the first instance, banks that do not make a profit should be restricted from paying dividends on ordinary equity and preference shares in order to preserve their capital levels.
- Second, in the event a bank's capital levels are depleted below the key 5.125% level, preference shares are converted to ordinary equity.
- Third, in the event that (i) losses now threaten the viability of the bank and (ii) capital markets are not willing to recapitalise the ADI then all subordinated debt is converted to equity.
- Fourth, should the above steps not be sufficient to stabilise the ADI, all equity is to be written off and a portion of all senior creditor capital, for instance 20%, is converted to equity. This becomes the new ordinary equity and the other portion (in this example 80%) remains as senior capital. Losses on the guaranteed deposits are to be covered by the Government which may recover some of these losses over time from the new equity it holds in the restructured bank.

Recommendation 7: Leverage Ratios

As noted in *Recommendation 1: Bank Capital Levels* a ratio of total capital to total assets is the stronger way to measure risk levels compared with the far easier to game system of risk weighted assets. The 4%, 6% and 8% levels proposed are a threefold leverage test that all banks should meet at all times.

Chapter 1: Issues Not Covered – Macroprudential Tools & Risk Culture

Macroprudential Tools

Macroprudential tools are an essential part of the tool kit for an effective bank regulator. **The blunt instrument of central bank overnight rates cannot be expected to deliver ideal rates of inflation, unemployment, GDP growth and credit risk taking all at the same time.** Macroprudential tools fill part of this gap, and they are particularly useful in economic environments where low base rates are leading to excessive risk taking. In conjunction with counter cyclical capital buffers, macroprudential tools can serve as a brake on excessive credit risk and/or credit growth.

Recommendations

- For institutional and investment banking lending, APRA should follow the US example of the Office of the Comptroller of the Currency (OCC), who undertakes an annual review of all syndicated loans above a set threshold under the Shared National Credit (SNC) program.
- For residential lending, the imposition of restrictions on high LVRs, second liens (both secured and unsecured), affordability tests, interest only loans and loan tenor should all be considered. Whilst only one or two measures may need to be adopted to be effective (particularly restrictions on high LVR loans), there is a range of options available.

The SNC program allows the OCC to review and grade the risk of the loans and set minimum capital holdings for each loan. One outcome of this process in the last twelve months has been that the OCC is setting maximum leverage for loans at six times EBITDA, effectively banning banks from holding loans rated (or of the equivalent risk to) B- or lower. These loans are therefore shifted away from the highly leveraged balance sheets of banks to better capitalised shadow banking lenders such as fund managers and CLOs.

SNC type reviews will also provide APRA with far greater insights on the quality of lending in the institutional and investment banking departments and allow for more accurate setting of countercyclical capital buffers. Initially, APRA is unlikely to have the staff with the required skill set to conduct all aspects of such a program. APRA should consider partnering with private sector credit analysts such as rating agencies or fund managers when assessing the credit risk of individual transactions.

Risk Culture

All too often, risk personnel are considered second class citizens relative to relationship managers, with this often enforced by a profit centre (relationship managers) having actual or perceived authority over a cost centre (risk managers). APRA has a substantial role in overseeing that risk personnel are adequately empowered to reject excessively risky lending activities at their financial institution.

Recommendations

- APRA should regularly engage with front line risk personnel at ADIs and monitor the key risk characteristics of new loans. This will require upskilling of APRA personnel so that they are able to “talk shop” with front line risk managers and are capable of assessing the risk of individual loans.

Recommendation 9: Broad Objectives for Superannuation

Target Retirement Balance

The primary purpose of superannuation is to increase the income of retirees thus reducing the demand on the Government for age based pensions. It therefore makes sense to encourage all working age Australians to target a specific retirement balance that will be sufficient to fund a decent lifestyle for at least 20 years.

Recommendations

- The Government should annually calculate a “target retirement balance” taking into account prospective inflation, investment returns and life expectation for a person aged 65. Different target levels may be appropriate for people living alone and couples sharing housing.

The taxation of superannuation should align with the target retirement balance, with a two tier system proposed. When contributors have less than the target balance a lower rate (for instance 15%) should apply to all contributions and income earned within the fund. Once the target balance is exceeded, then a higher rate of taxation (for instance 30%) should apply to contributions and income. By applying a higher taxation rate once the target balance is reached, the need for caps on annual contributions can be removed. The perceived tax subsidy for superannuation largely disappears when the higher taxation rate is applied to larger balances.

Portability of Superannuation

Superannuation is money put aside for retirement and as such it does not require daily or weekly liquidity. Allowing very short switching periods can encourage excessive switching which will increase the fees charged and decrease the overall return for members. Short switching periods also discourage long term investments, with more volatile but liquid assets (such as equities) required to match potential redemptions when less volatile direct ownership investments may be more optimal.

Recommendations

- Superfund members should be allowed to switch a maximum of once a quarter, with the each superfund required to notify its members of the dates in the year ahead when switches will be processed.

Financial Advice for the Majority of Australians

The debate over the provision of financial planning and advice is primarily focussed on advice for the wealthiest members of society. Given their larger balances of investable assets (i.e. excluding the primary residence), there is a much higher level of competition and quality of service available as wealth increases.

The majority of the population has less than $200,000 of investable assets and therefore fees for service can quickly amount to more than 1% per annum. **For many Australians basic financial advice is either not available at a reasonable cost or will be provided by groups with a vested interest such as staff at a bank branch or an adviser employed by their superannuation fund.**

Recommendations

- The need for a basic government funded financial education program is obvious. The pathway for providing this education is far less obvious. The Financial Literacy Board is a key group for advice on these issues.
- For the majority of the population, there are three basic points that sum up the financial advice they need:
  - spend less than you earn
  - pay off all your debts
  - take advantage of the tax benefits of superannuation to save for retirement
- The simplification of disclosure documents including one page summaries of the key risks, put at the very front of the disclosure document, will also assist. Consideration should be given to whether ASIC should ban particular products being sold to retail investors if they are deemed too complex to be understood.

Recommendation 10: Superannuation Fees

The introduction of MySuper encourages superannuation funds to offer two different strategies. The MySuper option should be the low fee and primarily passive management strategy with few or no additional features such as life,

disability and income protection insurance. Non-MySuper strategies could include higher fee asset allocations, such as private equity, hedge funds and high fee active management funds as well as insurance options.

Despite the substantial growth of funds in superannuation in the last decade overall fee levels have barely declined. It seems that the lack of explicit restrictions on fee levels has been to detriment of members with most superannuation funds and the fund managers they use having made limited progress in reducing costs.

Recommendations

- Products that bear the MySuper label should be subject to a maximum all-in annual fee of 0.50%, with the expectation that this cap will ratchet down in future years to levels competitive with international peers.
- All underlying investments or funds included in non-MySuper products should be subject to a maximum all-in annual fee of 0.50%, with performance fees excluded from this calculation and not restricted or capped.

Whilst the preference is typically to leave the market to resolve fee levels, the failure to meaningfully reduce fees and the cost of this failure on retirement incomes justifies intervention. MySuper products must be true to label and actually have very low fees. The recommended cap for non-MySuper products allows superannuation managers to choose active management strategies but requires that the underlying managers must perform well to be paid well.

Recommendation 17: Credit Card Surcharging

The current system has clearly not worked with airlines and the taxi industry flagrantly charging well beyond a cost recovery level for credit cards.

Recommendations

- Legislation should be passed immediately that makes it a criminal offence to charge more than cost recovery for credit cards including pretending that such fees are a "service fee". Those who have overcharged since the Reserve Bank issued the rules in 2013 should be required to refund consumers for the overcharging.
- To simplify the process, an absolute cap (for instance 1%) should be considered as a legislative maximum but with the onus remaining on those charging fees to be able to prove the costs incurred.

Recommendation 24: Disclosure of Conflicts of Interest and Use of Titles

Recommendations

- The use of titles such as financial advisor, financial planner and investment manager should be accompanied by a requirement for independence and a fiduciary duty. Those claiming independence should derive their revenue solely from their clients with all other revenues (commissions or bonuses) rebated to their clients.
- Those who cannot satisfy these requirements should be banned from using titles that indicate independence and should be required to clearly disclose their roles as sales people at the outset.

This could be a simple as *"I am a salesperson not a financial advisor which means that I may earn commissions by selling products and services to you. The products and services I am selling may not be in your best interest and you may want to seek independent financial advice before agreeing to purchase."*

Recommendation 29: Regulator's Funding and Powers

One of the lessons ASIC and APRA should learn from their US counterparts is that fines are an effective way of discouraging bad behaviour. **A secondary outcome is that regulators who are issuing fines and agreeing large financial settlements are using their powers to see that those behaving badly are paying a much larger share of the total cost of regulatory oversight.**

ASIC particularly has been weak in issuing fines and sanctions to the point where it is often called the "corporate watch puppy". **Despite evidence of fraud and forgery at the financial planning departments of Macquarie Bank and the Commonwealth Bank there appears to have been no fines issued or criminal charges laid.**

Recommendations

- Maximum fines prescribed by legislation need to be increased dramatically to take into account the damage caused by financial misconduct. For cases of serious misconduct fines in the range of 10-100% of the annual profit of an institution, as well as remediating damage suffered, should be standard.

The various US regulators are now commonly agreeing settlements in the billions of dollars with banks for conduct that is arguably no worse than occurred at Macquarie Bank and the Commonwealth Bank. In similar US cases, senior management are being forced to leave with bonuses paid in previous years being clawed back.

Fines of such large scale also enhance shareholder engagement as they cannot be considered a cost of doing business. Fines that reduce an annual profit by more than 10% are a significant motivator for shareholders to hold their boards and senior management accountable for misconduct under their watch. **ASIC appears to have forgotten it has the power to approve and revoke licences (which are essential for conducting business in the financial services sector) and therefore has no excuse for not severely punishing misconduct.**

Recommendation 33: Development of Debt Markets

It is commonly accepted that Australia has a relatively narrow and underdeveloped bond market compared to other countries, particularly the US. The predominant forms of debt funding for major corporations in Australia are syndicated loans and offshore issued bonds, with Australian listed and unlisted bonds a distant third. For institutional buyers of debt, such as insurance funds and superannuation funds, the syndicated loan market is a better format for taking credit risk. The common covenants and security packages embedded in syndicated loans makes them far less risky than the typical bond of the same credit rating. The Government should therefore encourage development of the syndicated loan market for non-bank institutions and the listed bond market for retail investors.

Recommendation 36: Insolvency and External Administration

Any discussion of insolvency reform must begin with the understanding that creditors of a company are the priority in insolvency and their right to be paid for goods or services provided is paramount. **Ordinary creditors (employees, trade creditors and the ATO) cannot be expected to assess and monitor the risk of not being paid.** Rather, they should be able to function with an understanding that their supply of goods and services is to a solvent entity that will pay the amount due within the time period agreed.

Company directors, senior management and financiers are in a position to assess risk and to take action if risk levels are excessive. In almost all cases of company insolvency, directors and senior management have ignored warning signs and have failed to raise equity or sell assets to strengthen the financial position of the company in the months and years prior to insolvency.

Companies that take excessive risk and fail to pay for goods or services received have effectively stolen from their creditors. The have engaged in a (typically undisclosed) “heads I win, tails you lose” gamble with their creditors capital. Company directors and senior management that preside over such failures should be responsible for losses incurred by ordinary creditors unless it can be proven that the situation was completely unforeseeable and that they have acted in a prudent fashion at all times.

Recommendations

- The most pressing issue to be addressed is the constant stream of companies that are found to have traded whilst insolvent for months or years. **The failure of ASIC to prosecute insolvent trading is intolerable with widespread criminal activity going unpunished.**
- Australia **should not** introduce a US court led insolvency process as it will substantially increase the cost and duration of insolvency and recovery processes. The current Receiver and Voluntary Administrator led system in Australia is far more efficient in solving problems and preserving value for creditors.
- Australia **should not** introduce safe harbour protections as failures will become larger and more costly, with insolvent companies benefitting at the expense of creditors. When experienced bankers and insolvency practitioners are asked for examples when Voluntary Administrators were appointed too early the only example regularly cited is Henry Walker Eltin.
- Australia **should** legislate against ipso facto clauses and require contracts to continue after insolvency, subject to the ability to pay future contractual payments on delivery of goods or services. Receivers and Voluntary Administrators should have 14 days after appointment to disclaim or continue all existing contracts. Creditors impacted by contracts disclaimed would have the same rights as currently exist for recovery.
- Australia **should** introduce a strict regime for order of priority of creditors with subordinated creditors and shareholders unable to receive funds or exert influence when a full recovery for senior creditors is doubtful.
- Australia **should** introduce a restricted account framework to protect trade creditors, employees and taxpayers, but not financiers in the event insolvency occurs. Company directors would (if they as a group chose to) be able to direct senior management to maintain sufficient funds in restricted accounts to cover all accrued trade creditors, employee liabilities (wages, leave and superannuation) and taxes.

As well as cost issues, the US system allows for management that often caused the financial issues to remain in control of the company and to fight against senior creditors for the benefit of shareholders. The current Australian system already allows for major creditors to work together and to grant a deferral of obligations, with standstills regularly given by banks to struggling borrowers. If a company cannot convince its creditors to forestall action it has no reason to continue to trade and to risk inflicting greater losses on its creditors.

There are many benefits to the proposed restricted accounts system including:

- Trade creditors would be far less likely to suffer loss on insolvency, stopping the chain of cascading defaults and insolvencies when one company’s failure to pay leads to other companies being unable to pay
- Taxpayers provide less in subsidies to failed businesses as more PAYG and GST owed would be collected and there would be fewer claims to GEERS

- Employees would receive their accrued wages, leave and superannuation despite the insolvency
- Non-executive company directors would not be personally liable if they oversaw the implementation and monitoring of the restricted account system
- Risk of financial loss would be primarily shifted onto financiers and shareholders, who are best positioned to evaluate risk and to price accordingly in any capital they provide
- Management and directors of phoenix companies would be far more obvious and far more exposed to the losses they cause. In the event a company failed and creditors other than financiers suffered loss then the CEO, CFO and the directors (if they did not implement and monitor the restricted account system) would be personally liable to make good all losses. ASIC would be required to disqualify all such individuals from any involvement in company management or directorships in the medium term.

Appendix 2: Taxation Issues

Key Reasons for Excessive House Prices

Australia regularly ranks at or near the bottom of indices of housing affordability. There are many factors that feed into this, with low interest rates and easy access to credit part of the issue. However, many other countries also have these factors without similar affordability issues. Overshadowing the private sector variables (cost and availability of credit) are the policies of the federal and state governments that have far more long term impact on house prices. **Analysis focussing on demand, supply and incentive factors highlights government created distortions.**

On the demand side, Australia continues to have relatively high population growth for a developed country due to both very strong net migration and natural increase. Whilst not entirely comparable given their higher population density, Hong Kong and Singapore are other examples of high population growth and low levels of housing affordability being interlinked.

On the supply side, government policy often restricts the release of land for housing or increases to the density of existing housing land, substantially increasing the cost of development. The supply of labour in the construction industry is also restricted which increases the cost of building.

The financial incentives offered by governments for owning housing include first home buyer grants, negative gearing allowances and capital gains tax reductions. Unlike many other developed countries Australia does not have the financial disincentive of land tax (a highly progressive form of tax) using stamp duty and developer levies instead. These opaque transaction costs are often forgotten or disregarded when investment decisions are made.

Without correcting these imbalances with a major overhaul of the taxation system, government schemes will have little or no positive impact on affordability. Contrary to the aim, **first home buyer grants have made housing more unaffordable and allowing potential buyers to withdraw superannuation to purchase a home would do the same.**

Development of Debt Investments

Simplifying disclosure requirements and making more debt instruments available via the ASX will somewhat help to increase the proportion of debt investments held by Australians. However, **the primary reason for Australia having a low level of debt investment relative to other countries is that our taxation system rewards investment in equity and property and penalises investment in debt products.**

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Equities and property benefit from capital gains tax reductions, negative gearing allowances and the rebate of company tax via franking credits. Debt investments receive no such assistance with interest received taxed at the full marginal income tax rate. These taxation policies have the effect of rewarding investors for making riskier investments and penalising them for making safer investments. The obvious outcomes are that Australia has relatively high house prices, is over-allocated to listed equities and the direct ownership equivalents (i.e. commercial property, infrastructure and private equity) and has banks that are reliant on international funding.

The penalising of debt investments is particularly harsh in a low interest rate environment. Investors on the top marginal tax rate currently receive negative real returns on even the best term deposit rates available. The elephant in the room for many of Australia's biggest financial system issues is the substantially outdated tax system.

Appendix 3: Availability of Credit for Small Businesses

Complaints about the lack of credit available for small businesses are almost always made by people who have a fundamental misunderstanding of the different roles of debt and equity in a capital structure. As debt has upside limited to the interest rate charged but the potential for 100% downside in the event of a company failure it is only suited to situations where (i) there is a very high likelihood of full repayment or (ii) if non-payment occurs then there is a high likelihood of losses being small.

The failure rate for small businesses varies between studies and time periods, but as a guide at least one-third of companies cease operating during their first five years. Most small businesses have no material hard assets which can be sold to repay creditors in the event of insolvency. As a result, few small businesses will be a good risk for a lender without additional security, such as the property of the owner, being offered to support the loan.

Given this high risk profile, the funding needs of most small businesses (and particularly those with no track record) are better matched with equity. This will most often be supplied from the savings of the founder/s, with angel investors, venture capital and crowd funding other avenues for equity financing. With an increasing number of non-bank lenders making debt finance available as well as the development of peer to peer funding platforms, small businesses have sufficient options available for debt financing providing they have a sufficiently low risk business proposition.

Recommendations

- The system in the UK where banks are obliged to make available lending enquiries that they declined so other lenders could potentially offer to provide finance is an idea worth considering.
- Proposals that compel lenders to take on high risk borrowers are a recipe for disaster and should be avoided. From both a risk analysis and cost efficiency perspective Australian banks are generally not well organised to provide funding to higher risk small businesses.
- Crowd funding and other equity raising mechanisms should be encouraged, as well as peer to peer lending.

End of Submission

Written by Jonathan Rochford for Narrow Road Capital on March 24, 2015. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

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