INSTITUTE OF PUBLIC ACCOUNTANTS®

Submission to the Treasury: Australian Business Securitisation Fund

January 2019

16 January, 2019

Lauren Hogan
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: ABSF@treasury.gov.au

Dear Ms Hogan

Australian Business Securitisation Fund

Thank you for the opportunity to comment on the draft Bill and Explanatory Memorandum (EM) relating to the establishment of the Australian Business Securitisation Fund (ABSF).

We note the brief period between the Government announcement of the ABSF and the release of the draft Bill and EM. In any event, the Institute of Public Accountants (IPA) is very pleased with this initiative and the Business Growth Fund.

In August 2015 the IPA Deakin University SME Research Centre released the first Small Business White Paper which included a chapter on the lack of affordable and accessible finance to SMEs and made recommendations to address this situation. The main recommendation focused on the establishment of a loan guarantee scheme, based on those which exist in almost all developed countries. This specific recommendation was included in subsequent IPA pre-Budget submissions and has been adopted by various political parties at Federal and state levels.

However, the lack of affordable and accessible finance and capital for SMEs persists, as reflected in the empirical evidence contained in the second Small Business White Paper, which was released by the IPA Deakin SME Research Centre in September 2018.

The full version of the Small Business White Paper can be found on the IPA website,

https://www.publicaccountants.org.au/news-advocacy/small-business-white-paper

We note the discussion on lending to SMEs in the interim report of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services.* We also acknowledge the report of the Australian Small Business and Family Enterprise Ombudsman from the *Affordable Capital for SME Growth* inquiry, to which the IPA Deakin SME Research Centre contributed.

With respect to the draft Bill and EM for the ABSF, the IPA notes that an SME does not appear to be defined. We suggest that a definition will be needed and that it should be as broad as possible to increase the number of entities that can take advantage of the ABSF. Our submission has a detailed discussion of definitions of 'SME' from around the world.

Despite the lack of detail in the draft Bill and EM, the IPA appreciates that the ABSF will be monitored and adapted once it is established to try and ensure its success; with a review process included.

In our submission we have included a broad discussion around access to finance for SMEs and some of the research and policy which we believe should be applied to frame the legislation and regulations and any rules. Given the brevity of the draft Bill, these ancillary documents may benefit from the discussion in the IPA Deakin SME Research Centre's Small Business White Paper which is included below (in part). In particular, we refer to the OECD (and G20) '*High-level Principles on SME Financing'.* These can be used to assess the future performance of the ABSF as well as informing future policy on SME financing more broadly and especially after the ABSF has been operating.

We believe that it will be critical to the success of the ABSF to develop the appropriate operating environment, including raising awareness of its existence and benefits. For this reason we have also included our recommendations from the Small Business White Paper.

We wish to emphasise that in order for the quality, benefits and impact of the ABSF, Growth Fund and other SME and innovation initiatives to be shaped, monitored and measured, it is critical that independent researchers, such as those at Deakin University and the SME Research Centre, are given access to quality data. Despite the fact that the Government has launched its open data policy, there are still serious constraints in attempting to obtain access to data.

The Australian Bureau of Statistics' (ABS) Business Longitudinal Analysis Data Environment (BLADE) is the most comprehensive firm level statistical asset in Australia. However, only staff employed by the ABS, directly or through secondment, can currently access BLADE. BLADE is valuable because it currently integrates various government data sources for analysis via the ABS business register. Government data sources that BLADE integrates are ABS Survey Data (eg, Business Characteristics Survey, Economic Activity Survey and R&D), ATO data (eg, BAS, BIT and PAYG), Department of Industry, Industry and Science (DIIS) program data, and IP Australia data.

Deakin University researchers have developed a significant research proposal for a Data Integration Partnership for Australia project, which focuses on the quality and impact of SME innovation. There are three objectives which directly and indirectly fall within Treasury and the Treasury portfolio. At this stage the proposal is confidential, however, the Deakin researchers would welcome the opportunity to discuss this proposal in greater detail and to put the case for access to BLADE. In the meantime, we persist in our efforts to obtain access to BLADE and appreciate any assistance and support in this regard.

If you would like to discuss our submission, please contact me at either vicki.stylianou@publicaccountants.org.au or on mob. 0419 942 733.

Yours sincerely

Vicki Stylianou
Executive General Manager, Advocacy & Technical
Institute of Public Accountants

About the IPA

The IPA is one of the three recognized professional accounting bodies in Australia. Representing more than 35,000 members in Australia and in over 80 countries, the IPA represents members and students working in business, commerce, government, academia and private practice. Three-quarters of our members work in or advise the small business/SME sectors. Since merging with the Institute of Financial Accountants of the UK in 2014, the IPA Group has become the largest accounting body in the world working in the best interests of our members, the profession, small business and SMEs.

Recommendations related to finance principles and alternative financing

Given the importance of SMEs as significant contributors to (and drivers of) GDP, we recommend that the federal government should:

- Review its current policy settings for SME finance to ensure it follows world's best practice (as specified by the G20 and OECD)
- Provide appropriate incentives that encourage financial institutions to urgently re-examine their finance offerings for SMEs
- Initiate loan guarantee schemes
- Allocate priority funding to vocational education courses to enhance SME owners' financial literacy, business strategy and management skills
- Provide incentives (such as tax deductibility for education costs) to SME owners for financial literacy and business management education
- Fund research initiatives to support the work of the OECD in developing a generally-accepted definition of SMEs
- Support initiatives for the introduction of a new bank that services the specific financing needs of the SME sector
- Pass legislation allowing proprietary companies to take advantage of equity crowdfunding. (This has not been repeated here but can be found on the IPA website.)

Governments and financial institutions can address the finance gap through alternative finance models such as more asset-backed loans (including the recognition of intangible assets as collateral), project financing and leasing.

Governments, financial institutions and industry groups should also encourage SMEs to use alternative sources of finance as a means of bridging the SME finance gap.

Finance principles and alternative financing

Headline findings

- OECD reports (supported by the G20) explore innovation in SME finance.
- There is a need to broaden the terms of traditional lending to SMEs.
- Alternative options for SME finance, such as asset-based lending, are growing in popularity.
- There is an urgent need for governments to revisit loan guarantee schemes for SMEs.
- Financial literacy: training in finance and related disciplines helps achieve better financing outcomes for SMEs.
- There is an urgent need to develop a generally-accepted definition of an SME.

Introduction

In the first Small Business White Paper1 (hereafter WP1), the IPA-Deakin SME Research Centre (then known as the IPA Deakin University SME Research Partnership) provided theoretical and practical support to a government-backed loan scheme for SMEs, and highlighted various forms of equity-based finance for SMEs, including venture capital, for which we also recommended a publicly-supported venture capital fund. In the current paper, we note that credit conditions and access to debt capital continue to play out as major constraints for SMEs2 in Australia and, with the exception of some state-based financing initiatives, Australia is still counted among the few developed countries that do not have a government-backed loan scheme for small businesses.

The significance of SMEs in contributing to economic growth and prosperity is well documented in countless private surveys, in an almost endless list of contributions from investigatory journalists, and in a plethora of scholarly articles3. While governments around the world have long recognised that the SME sector is the engine room that drives their respective economies4, more intervention by governments is needed in some countries (including Australia), to mitigate or remove significant constraints impacting SMEs. Counted among the more prominent constraints identified by Australian business owners are the lack of access to debt financing, high taxes and ongoing regulatory imposts.5

The Australian government, to its credit, has introduced significant policy and legislative reforms as part of its comprehensive SME agenda, including changes to the financial system

[1] IPA Deakin University SME Research Partnership (2015).
[2] Scottish Pacific Business Finance (2017), p13.
[3] An excellent review of the SME finance literature is provided in Kersten et al (2017)
[4] Scottish Pacific Business Finance (2017).
[5] Scottish Pacific Business Finance (2017).

to accommodate greater access to debt finance for SMEs, and the introduction of a range of tax incentives targeting small businesses and particularly innovative start-ups.

Table 1 shows that there has been continued growth in new lending to SMEs since 2007 – in particular, an increase of 5.13% in 2014 followed by an increase of 7.32% in 2015. However, new loans to SMEs declined by 4.9% during 2016. Moreover, while total outstanding loans to SMEs increased during 2015 by 4.05%, there was a 3.9% decrease in total outstanding loans during 2016. This is consistent with the decrease in the number of SME bankruptcies, which declined to a new low of 36 per 10,000 in 2016. Similarly, venture and 'late stage' capital investments, combined, grew by 4.7% during 2016, whereas leasing and hire-purchase volumes decreased by 8.62%.

Table 1: Financing SMEs - Australia, 2007-2016

Indicator		Unit	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	% change 2014/15	% change 2015/16
Debt	Outstanding business loans, SMEs	AUD million	188,709	203,880	203,598	223,624	234,271	238,267	241,220	249,855	260,282	270,408	4.17%	3.89%
	Outstanding business loans, total	AUD million	710,887	771,942	721,345	705,885	714,619	737,796	749,726	784,781	835,077	881,298	6.41%	5.53%
	Share of SME outstanding loans (% of total outstanding business loans)	Percentage	26.55%	26.41%	28.22%	31.68%	32.78%	32.29%	32.17%	31.84%	31.17%	30.68%		
	New business lending, SMEs	AUD million	77,517	79,914	69,562	82,506	81,561	73,674	79,130	85,373	91,126	86658	6.74%	-4.90%
	New business lending, total	AUD million	374,997	336,145	265,484	265,820	310,696	273,774	292,430	360,436	391,641	341,766	8.66%	-12.73%
	Share of new SME lending (% of total new lending)	Percentage	20.67%	23.77%	26.20%	31.04%	26.25%	26.91%	27.06%	23.69%	23.27%	25.36%		
	Interest rate, SMEs	Percentage	8.56	7.99	7.56	8.29	7.94	7.07	6.44	6.18	5.58	5.29		
	Interest rate, large firms	Percentage	7.6	6.16	5.85	6.67	6.37	5.29	4.29	4.15	3.59	3.2		
	Interest rate spread (% points)	Percentage	0.96	1.83	1.71	1.62	1.57	1.78	2.15	2.03	1.99	2.09		
Non-bank finance	Growth capital and venture capital	AUD million	6,939	8,315	7,903	8,912	8,700	7,652	8,348	7,907	8,802	9,213	11.32%	4.67%
	Growth capital and venture capital (%, Year-on-year growth rate)	Percentage	…	19.83	-4.95	12.77	-2.38	-12.05	9.1	-5.28	11.32	4.67		
	Leasing and hire purchases	AUD million	9,546	9,342	6,904	7,140	7,579	8,691	7,549	8,690	10,368	9,474	19.31%	-8.62%
	Factoring and invoicing	AUD million	54,757	64,991	63,101	58,661	61,422	63,361	63,272	62,391	64,400	…	3.22%	
Other indicators	Bankruptcies, SMEs (Total)	Per 10,000 businesses	45	47	47	50	51	53	49	39	41	36	5.13%	-12.20%
	Bankruptcies, SMEs (%, Year-on-year growth rate)	Percentage	..	4.44%	0.00%	6.38%	2.00%	3.92%	-7.55%	-20.41%	5.13%	-12.20%		

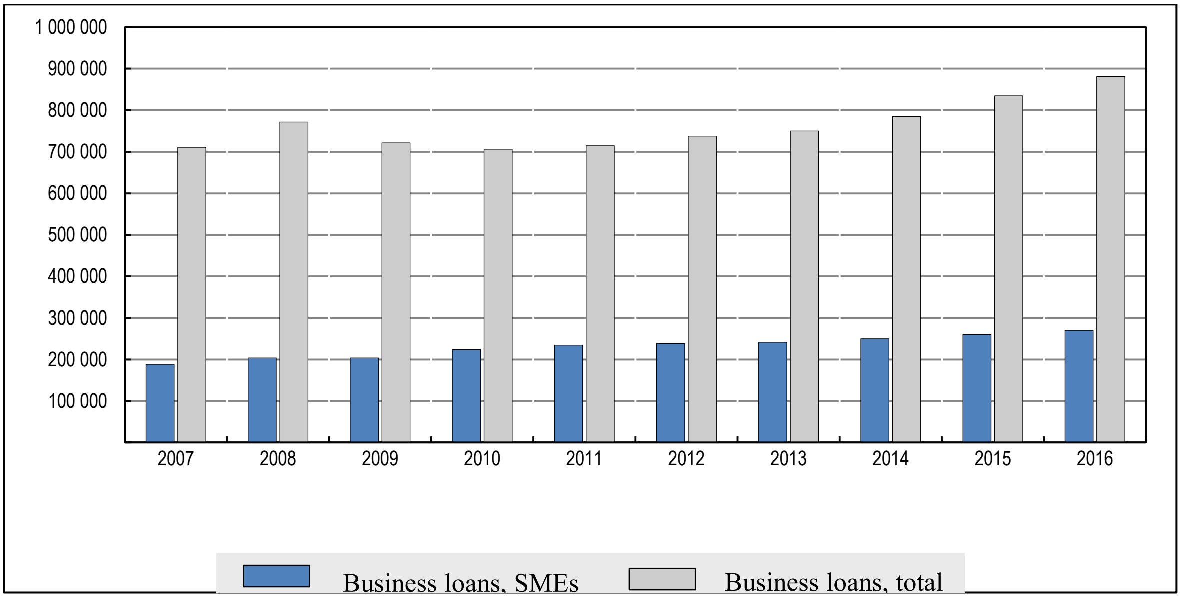
Source: OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. http://dx.doi.org/10.1787/fin_sme_ent-2018-en. Accessed 29 May 2018.

In the Australian context, whether these increases in various forms of finance intended to assist the SME sector can be attributed to the government's SME financing reform agenda, or are attributable to moderate improvements in the Australian economy following the global financial crisis and the end of the decade-long mining boom, remains unclear. The IPA-Deakin SME Research Centre supports government initiatives from which it is hoped SMEs will benefit, particularly those initiatives that bring positive changes to SME financing, such as Australian-based crowdsourced funding, applicable to public companies from 1 September 2017. Moreover, the IPA-Deakin SME Research Centre commends the federal government's proposed changes to corporate law that allow proprietary companies to engage in crowdsourced funding activities. This is a promising initiative that will be particularly beneficial to the SME community.

Financing the SME sector

The IPA-Deakin SME Research Centre maintains that the financing issues confronting SMEs, as observed in WP1 (and briefly reiterated here), still continue to be problematic for SMEs, on both the demand side and the supply side. This suggests that sub-optimal lending continues to persist in the SME sector in Australia. On the demand side, SMEs continue to compete with their larger counterparts in highly-competitive debt markets. Notwithstanding their ability and willingness to pay[6], Figure 1 shows that there remains a considerable gap between lending to SMEs and total business loans.

Figure 1: SME and total business loans, Australia (2007-16) ($A millions)



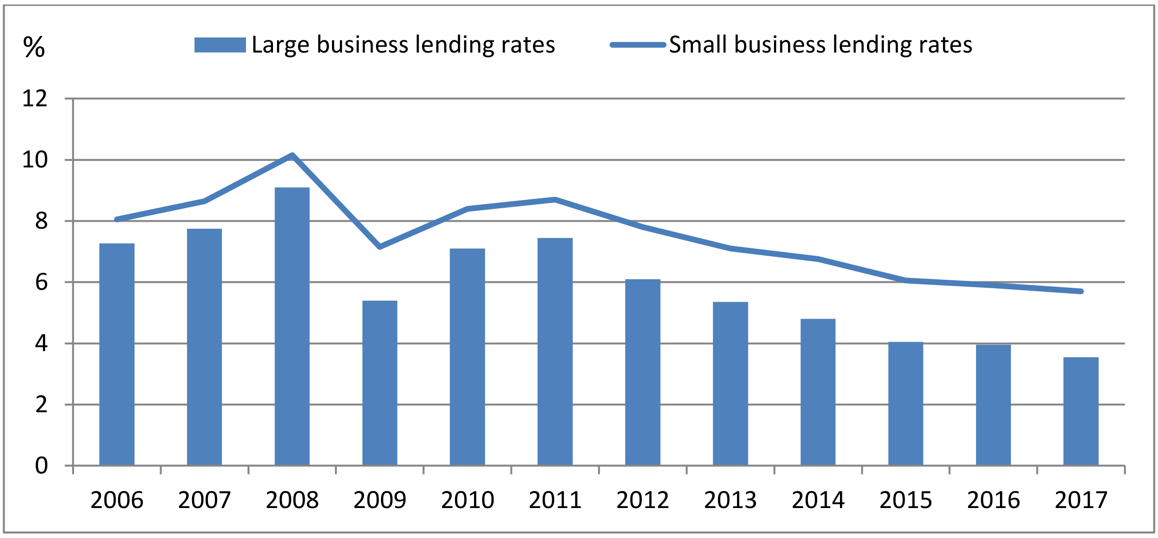
Source: OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. *http://dx.doi.org/10.1787/fin_sme_ent-2018-en. Accessed 4 June 2018.*

Financial literacy issues also appear to be at the heart of demand constraints, with entrepreneurs new to the market often lacking knowledge about finance, strategic management and the extensive range of financial products available to start and sustain their businesses. Against this background, the ability to formulate and articulate a sound business strategy (sufficient to convince and woo potential lenders and investors) can be a major impediment in accessing much-needed funds.

The IPA-Deakin SME Research Centre further notes that the spread in Australian interest rates between large enterprises and SMEs continues to persist. Although the average interest rate on loans to the SME sector in Australia is decreasing, as shown in Figure 2, interest rates generally in Australia remain relatively high compared to those in other developed countries. This phenomenon has a flow-on effect on SME loans.

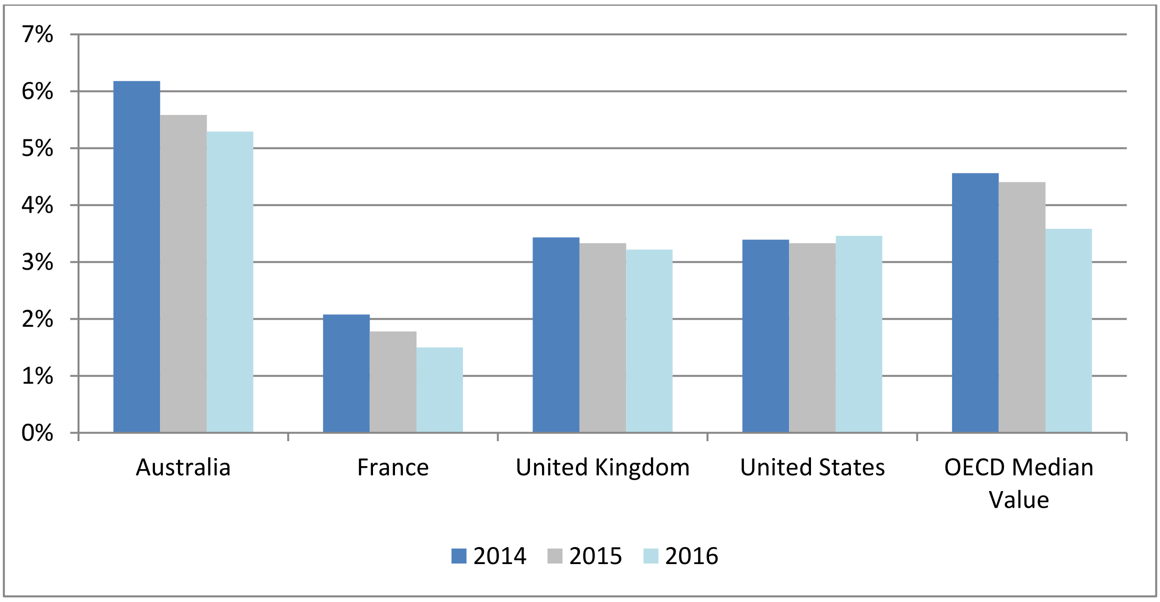
[6] IPA Deakin University SME Research Partnership (2015), pp 23-27.

Figure 2: Interest rates charged on small business loans, Australia (2006-17)



Source: Data compiled from Reserve Bank of Australia (RBA).

Figure 3: SME interest rates (2014 -16)



Source: Data compiled from OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. [http://dx.doi.org/10.1787/fin_sme_ent-2018-en.](http://dx.doi.org/10.1787/fin_sme_ent-2018-en) Accessed 26 May 2018.

On the supply side, banking institutions continue to be cautious, post-financial crisis, in lending to SMEs, and particularly to small emerging and innovative enterprises. This is primarily due to the lack of a credible trading history and thus the higher risk profiles of SMEs compared with larger, more established firms. There is a persistent 'information asymmetric' phenomenon that is well documented in the finance literature. Given these circumstances, it is not unreasonable to expect the presence of a 'spill-over effect' at play in the market for debt, whereby lenders fail to recognise the positive externalities generated by SMEs, such as more jobs, new and innovative products, and ultimately more economic growth.[7]

Many of the above issues were covered in some depth in WP1. Rather than reiterating the same arguments here, the IPA-Deakin SME Research Centre explores new forms of funding currently trending within the SME and entrepreneurship space. Among the more interesting of these include crowdsourced funding (hereafter 'crowdfunding'), a new funding source that has recently become available in Australia for public companies due to changes in corporate law. Crowdfunding will also potentially soon be available for proprietary companies.

The IPA-Deakin SME Research Centre further notes that the public flotation route for SMEs at the upper end of the size scale and, in particular, family businesses, is gathering momentum in Australia and in offshore jurisdictions as a potential longer-term alternative to debt finance.[8]

A new bank for SMEs to challenge the 'four pillars' policy?

The IPA-Deakin SME Research Centre was heartened by an article in *The Age*[9] reporting on the launch of a new bank, Judo Capital, in March 2018. Judo Capital will primarily operate within the SME finance sector and thus is destined to fill the $60 billion shortfall in lending to SMEs. Even more encouraging are the sentiments expressed by Kate Carnell, Ombudsman for Small Business and Family Enterprise, which acknowledged that there is "no competition" in the banking system, and that "The big 4 banks have 80% plus of the SME lending market and they mostly don't lend except if it [the loan] is secured against property and that means access to capital is very difficult for many SMEs".

In the same article, Cara Waters quotes Joseph Healey, co-founder of the new bank, who explains that "We saw a new opportunity to go back to relationship-centric banking as it used to be and banking as it should be". This is an interesting observation, as the IPA-Deakin Research Centre (through is joint partner the IPA and its membership) has noted that one of the most common complaints from SME owners is the lack of relationship with their bankers.

While the IPA-Deakin Research Centre strongly supports the initiative to establish a new bank which focuses on SMEs and their financing needs, it will be interesting to observe how this new initiative will play out in the future, that is, as the potential saviour for SMEs. Indeed, given the comments by Waters[10] that the bank will focus on the four 'C's of banking – character (i.e. the SME's history and risk appetite), future cash flows, current capital base, and collateral – how will this bank be any different to the existing banks? If collateral is the

[7] IPA Deakin University SME Research Partnership (2015), pp 23-27.
[8] Deloitte (2017).
[9] Waters (2018).
[10] Waters (2018).

focus then, in reality, the new bank might adopt similar strategies and practices as the big 4 and thus add to the existing oligopolistic banking architecture in Australia.

Alternative forms of finance for SMEs

A good starting point for examining alternative forms of finance for SMEs is to firstly recognise the work of well-respected international bodies that support the drive for alternative sources of finance for SMEs, micro-enterprises and entrepreneurs generally. In this respect, it is important to acknowledge two notable bodies working together toward the development and endorsement of '*High-level Principles on SME Financing'* – the Organisation of Economic Cooperation and Development (OECD) and the Group of Twenty (G20), of which Australia is an active member.

In April 2015, G20 finance ministers and central bank governors requested the development of a set of high-level principles on SME financing by the OECD. The rationale for this request stemmed from the need for G20 and OECD members "*to support their efforts to enhance access to a diverse range of financing instruments by SMEs, including micro-enterprises, and entrepreneurs"*.[11] Further, "*Cross-cutting policies to enhance SME access to finance are needed to provide a coherent framework for government actions in this area, within the broader policy ecosystem for SMEs. Such strategies are instrumental to define specific policy objectives; design, coordinate and implement policy measures; and to provide a framework for monitoring and evaluation".*[12]

In September 2015, an 'in-progress' draft of the high-level principles on SME financing was tabled at a meeting of G20 finance ministers and central bank governors. In July 2016, the OECD published their report titled *Progress Report on the Development of Effective Approaches to Support the Implementation of the G20/OECD High-level Principles on SME Financing.*[13] Given their importance in guiding and setting government policies that will ultimately support greater access to finance by SMEs, we have listed the 11 principles here.

Table 2: High-level principles on SME financing

1. Identify SME financing needs and gaps and improve the evidence base.
2. Strengthen SME access to traditional bank financing.
3. Enable SMEs to access diverse non-traditional bank financing instruments and channels.
4. Promote financial inclusion for SMEs and ease access to formal financial services, including for informal firms.
5. Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection.

[11] OECD (2015b), p 5.
[12] OECD (2015b), p 5.
[13] OECD (2016).

6. Improve transparency in SME finance markets.
7. Enhance SME financing skills and strategic visions.
8. Adopt principles of risk sharing for publicly supported SME finance instruments.
9. Encourage timely payments in commercial transactions and public procurement.
10. Design public programs for SME finance which ensure additionality, cost-effectiveness and user-friendliness.
11. Monitor and evaluate public programs to enhance SME finance.

Source: OECD (2016), G20/OECD Progress Report on the Development of Effective Approaches to Support the Implementation of the G20/ OECD High-level Principles on SME Financing, July 2016, OECD Publishing, Paris.

Interpreting the high-level principles of SME financing

From extensive discussions with IPA members and their clients during roundtable meetings, various IPA events, seminars, forums and congress, the IPA-Deakin SME Research Centre is constantly reminded that the ability of entrepreneurs and/or SME owners to achieve their desired business goals is only in-part facilitated by a particular set of skills, or a unique idea, concept, product or business model. What is also critical is access to reliable, affordable and sustainable funding sources, many of which are often overlooked or simply not fully understood by those SME owners who critically depend on these sources. With new forms of financing emerging and becoming more and more available and accessible to SMEs and entrepreneurs, it is timely for governments and other professional bodies to fully articulate the benefits of these new products to the SME community.

Some of the alternative and emerging financing options have been thoroughly analysed by global organisations such as the G20 and the OECD. These two organisations have expended significant resources and time over the past decade focusing on mechanisms that encourage both developed and less-developed countries to adopt, as a central policy objective, the development of their financial system to provide those entrepreneurs operating SMEs with a range of financing options. These new options support appropriate funding mechanisms for SMEs to facilitate business success.

In particular, the underlying purpose of the work undertaken by the G20 and the OECD in recent years is to establish the key areas that governments, government departments, central banks and other banking institutions and private sector organisations should consider when designing policies that aim to improve SMEs' access to finance. While the high-level principles were initially prepared in the context of a body of work by the G20 and OECD on improving SME financing in the developing world, the IPA-Deakin SME Research Centre believes they provide a useful framework for evaluating policy initiatives aimed at improving financing opportunities for the owners of SMEs in Australia.

The IPA-Deakin SME Research Centre further believes that the principles outlined below are eminently suitable for setting government policy related to SME finance. Moreover, the principles are also a way that Australia can assist its trading partners – particularly those with underdeveloped financial systems – to support employment growth of their own SME sectors.

In the White Paper the IPA Deakin SME Research Centre reviews and discusses each of the principles in more depth, with particular emphasis added on their relevance to Australian SMEs and the Australian economy generally.

Considering each G20/OECD high-level principle on SME financing in turn

Principle 1 (OECD 1) – Identify SME financing needs and gaps and improve the evidence base

The IPA-Deakin SME Research Centre's interpretation of this principle is that policy decisions must be driven by an evidentiary base (i.e. the availability of accurate financial and non-financial data relating to SMEs), as well as an understanding of the marketplace served by any proposed or existing initiative. It is important that policy decisions in the area of SME financing are based on research that is credible and able to be used as a foundation for discussions on new policy settings or the revision of existing policy settings.

Some stakeholder groups that would be a part of such a dialogue would include key government agencies such as central banks and other financial regulatory agencies, small business industry/professional groups and other relevant bodies operating in the finance sector. The G20 and OECD have constantly emphasised the importance of the availability of accurate statistical and non-statistical information from which prudent policy directions can be developed. This is an observation which is fully endorsed by the IPA-Deakin SME Research Centre.

Indeed, given the IPA-Deakin SME Research Centre's concerns regarding the availability and reliability of research data applicable to the SME sector, the IPA and Deakin University jointly established the IPA-Deakin SME Research Centre in 2014. The Centre has the primary task of undertaking high-level technical research relating to SMEs. It was established to meet the growing demand for quality research on SMEs and related topics. This demand has emerged as a direct consequence of the phenomenal growth of the SME sector in most economies around the world and the recognition by governments of the significant role the SME sector plays in contributing to employment growth and increasing GDP.

A further element of concern by the G20/OECD relates to data analysis and research – in particular, the manner in which data on SMEs is collected, recorded and translated within domestic markets, and whether the data in its final form is able to be used for international comparability. In this regard, member countries need to adopt a data collection/processing framework which ensures that similar procedures and processes are consistent, thus enhancing the reliability and comparability of data relating to SMEs.

Quantitative measures, however, tell only one side of the story. Every country adds its own cultural aspects to the institutional/regulatory environment in which business is conducted. Any quantitative analysis will need to be tempered with an acknowledgement of those cultural and institutional peculiarities that impact results observed by the researchers. There are further, and perhaps more serious, challenges for those attempting to create a comparable database for SMEs. A primary, important consideration would be the need to adopt a consistent definition of an SME across jurisdictions, and preferably a definition which could have global application. While it is appealing, conceptually, to derive a consistent and perhaps generally-accepted definition of an SME, research has shown that definitional consensus has been problematic, even within a jurisdiction covering a defined group of related countries, let alone a global definition. For example, one study has shown that there are no less than 10 definitions of SMEs within the countries of the ASEAN community[14] and, as well, there are sub-definitions within the primary definition for some countries (See Appendix A). This is an interesting finding, particularly given that many of the countries within the ASEAN group have similar cultural and institutional settings.

Australia is also not without SME definitional diversity that potentially could impact the interpretation of research data. For example, three key government agencies define an SME differently (viz, the ATO, the ABS and ASIC). At this point, we believe it is important to draw on the findings in the literature to help our understanding of the extent of SME definitional diversity and whether it is possible to derive a generally-accepted definition of an SME which can be operationalised. Consideration needs to be given to the benefits derived from establishing a generally-accepted definition of an SME.

The extant SME literature maintains that, while SMEs account for more than 95% of all firms in many countries – playing a major role not only in ASEAN countries such as, for example, Indonesia, Malaysia, Thailand, Vietnam, but also in developed countries such as Japan, Canada, US, the UK and Australia[15] – there is nonetheless considerable diversity in the definitions of SMEs among different jurisdictions[16]. This diversity of definitions, which primarily relates to a lack of consensus on common size thresholds of the SME sector across countries, has created problems of comparability and consistency, which in turn can create significant validity issues.[17]

Furthermore, while different jurisdictions adopt differing criteria based on employment, sales, total net assets or investment to determine an SME, even within a specific criterion such as employment, there is no uniformity across different countries.[18] For example, the Philippines uses three employment levels (i.e. micro = 1 to 9, small = 10 to 99, medium = 100 to 199 employees) to define SMEs across all industries, while both Thailand and Vietnam use

[14] Mroczkowski, Tanewski and Kiaterittinun (2017).
[15] Allee and Yohn (2009); Chiao, Yang and Yu (2006).
[16] For example, Ayyagari, Beck and Demirguc-Kunt (2007).
[17] Ayyagari, Beck and Demirguc-Kunt (2007); Luger and Koo (2005).
[18] Ayyagari, Beck and Demirguc-Kunt (2007).

differing employment levels for different industry sector groupings (e.g. 'manufacturing', 'retail', 'wholesale', 'services and other' in Thailand; 'agriculture, forestry and fishery', 'industry and construction', 'trade and services' in Vietnam).

Of greater concern are the numerous studies reported in the extant literature that "… employ different, often *ad hoc*, approaches to the definition and measurement of key [SME] concepts"[19], casting doubt on the validity of these studies showing substantial growth within the SME sector[20]. Consequently, inconsistencies between these studies create a generalisability problem and weaken their external validity, diminishing the impact of the message on policy makers.[21] While this evidence relates mainly to start-up enterprises, their findings nonetheless have relevance to the current WPII and can equally apply to the SME sector.

Accordingly, there is an urgent need to provide an omnibus definition of SMEs, not only for the ASEAN region but also for other jurisdictions, and possibly a global definition. While it is acknowledged that no single definition of SME will suit all the needs of government or the private sector, the IPA-Deakin SME Research Centre argues that it is possible, by examining the four most common attributes relating to the definitions of an SME in the literature (annual turnover/sales, number of employees, total net assets or total investment, or a combination of the four criteria) it may be feasible to develop a generally acceptable (and operational) definition of SMEs. Doing so would enhance measurement and comparability between countries within the G20 and between other external jurisdictions, and will assist in addressing some of the validity issues related to data and statistical analysis.

We are cognisant of the importance of developing a robust definition of SMEs that is theoretically appealing and generally accepted within both academic and professional circles. It is reported in the extant literature that SMEs have some fundamentally different characteristics from large organisations – these are that SMEs are generally resource-constrained, they utilise informal strategies, create flexible structures, and they are reactive to their market environments.[22] As a consequence, SMEs tend to have higher failure rates compared to larger organisations. For example, the literature reports that 24% of all new businesses in the United States fail within two years and that 63% fail within six years[23], with similar failure rates observed in Australia, the United Kingdom, Japan, Taiwan and Hong Kong[24].

Due to SMEs' differing characteristics, the IPA-Deakin SME Research Centre argues that the resource-based view (RBV) of the firm is one of a number of theoretical frameworks that can be used to develop a robust definition of SMEs that will assist in explaining the manner in which SMEs develop competitive advantage. The RBV focuses on sustainable and unique costly-to-copy attributes of the firm as the sources of economic rents – as the fundamental

[19] Luger and Koo (2005), p 17
[20] For example, Joshi, Yapa and Kraal (2016).
[21] Luger and Koo (2005).
[22] Terziovski (2010); Qian and Le (2003); Hudson, Lean and Smart (2001); Hudson, Smart, and Bourne (2001).
[23] Wheelen and Hunger (1999).
[24] Lu and Beamish (2001).

drivers of the performance and sustainable competitive advantage needed for firm survival and success. Given the heterogeneity of small firms and their operating environments, there are fundamental difficulties in seeking to identify and define the critical resources needed for survival and success. By focusing on the attributes and resources that an SME should possess to sustain a long-term competitive advantage, the literature proposes that resources must be valuable, rare, not readily imitated and not substitutable[25], while other researchers argue that resources must capture durability, transparency, transferability, and replicability[26]. Resources in general can be considered stocks of available tangible or intangible factors that are owned or controlled by the firm and converted into products or services, using a variety of other resources and bonding mechanisms.

The RBV approach is useful for definitional purposes as it focuses on identifying observable characteristics that explain the source of a firm's competitive advantage as the basis for business success, and how the firm can maximise its value by combining and using all available resources to improve its processes.[27] In addition, the definition must also be able to be operationalised; that is, be sufficiently functional with criteria that can be readily applied in practice, particularly in a measurement context.

From studies undertaken by the IPA-Deakin SME Research Centre thus far[28], it would seem that functionality and application of criteria in defining an SME does not appear to be a major issue. Rather, the problem seems to be the significant diversity in the definitions of SMEs, making it difficult for relevant measurement and comparability across jurisdictions. As previously mentioned, there are nonetheless many common elements in the definitions used in different countries around the world. There is also commonality with definitions applied by authoritative bodies such as the World Bank Group (WBG), the Organisation for Economic Cooperation and Development (OECD), the Asian Development Bank (ADB), the International Monetary Fund (IMF), and the International Federation of Accountants (IFAC). From our research, what appears to be emerging is that three criteria are common across most definitions, namely:

1. the number of employees
2. the total amount of revenue
3. the total amount of assets (both current and non-current).

While further research still needs to be undertaken, we envisage that the substance of an omnibus definition will be based on the three criteria mentioned above.

Given the themes and theories briefly discussed above, we should pose the obvious question here – Would an operational definition of SMEs that is theoretically appealing and generally accepted within both academic and professional circles provide positive, meaningful benefits to interested stakeholders? The IPA-Deakin SME Research Centre argues that

[25] Barney (1991).
[26] Grant (1991).
[27] Teece, Pisano and Shuen (1997).
[28] IPA-Deakin SME Research Centre (2017).

deriving a generally-accepted definition of an SME will result in a significant reduction in definitional diversity which, in turn, should allow for 'better' and more accurate measurement in future research. Just as it is critical in the natural sciences to clearly delineate species for the purposes of accurate and meaningful research relating to individual species, so too is the case with enterprises within economies. For example, researchers may discover that there are more entrepreneurs working within the SME sector than there are in large listed companies.

Given the global pressures for national economies to innovate and remain competitive in world markets, it might be socially prudent and economically desirable to offer incentives (such as tax breaks) to SMEs. This type of thinking is currently in place in countries such as the United States and the United Kingdom, inter alia via a 'Patent Box' initiative where tax incentives are offered to certain business groups to stimulate innovation. In this sense, having an SME definition which is consistent among the various parties involved with incentive schemes (such as government departments, regulatory bodies such as the tax office and corporate regulators etc) ensures that the right parties are the beneficiaries of such incentive schemes. Having a common definition will also be vital to organisations that collect statistical data for the purposes of analysis which might impact government policy. Recognising that SMEs are significant contributors to world economies on so many levels (such as for example, employment, innovation, growth, income and so on), governments may wish to encourage the SME sector with incentives, thus preserving an important engine of business.

Principle 2 (OECD 6) – Improve transparency in SME finance markets

Information collected by government in relation to trends in SME financing will form one component of a more transparent approach to the collection of information related to all aspects of financing smaller entities. It is also important that the so called 'information asymmetric' phenomenon relating to SMEs is identified within financial markets and is constantly monitored to better understand the implications on public policy development for SME finance.

This would be greatly assisted by a review and revision of the legal and regulatory frameworks for credit reporting systems so that they are more relevant to the SME market. Moreover, a review of the way small businesses have their credit risk assessed may be warranted, particularly if the outcomes establish a need to improve techniques for credit risk assessment for SMEs. For any review of this nature, critical information (such standardised credit risk methodologies) must be accessible to policy makers, financial institutions and SME stakeholders in Australia and overseas.

Principle 4 (OECD 10) – Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection

History has shown that legal and regulatory systems cannot afford to be static in respect of both financial markets and product innovation, which are constantly evolving and, as a result, have led to an explosion of new laws, regulations, guidelines, pronouncements and so on. Unfortunately, many of these changes have taken a broad brush approach which often manages to unnecessarily capture even the smallest of enterprises, entangling them into a web of legislative compliance costs; which some may call unintended consequences. It is against this background that the G20 and OECD are recommending a review of all legal, tax, prudential and other levels of regulation to assess whether they are able to be amended to create an environment where SME finance is easier to obtain. The IPA-Deakin SME Research Centre wholeheartedly supports this initiative as over-regulation continues to trend as one of the most common complaints from the IPA membership and their clientele.

The IPA-Deakin SME Research Centre considers that the notion of 'risk-based regulation', discussed elsewhere in this paper, needs to be at the heart of developing policies, laws and regulations that:

- reduce *red tape* wherever possible for SME finance applications
- encourage best-practice corporate governance for SMEs
- enhance international coordination on matters of international regulation, and
- participate in knowledge-sharing in relation to the shaping and drafting of laws and regulations that deal with new sources of finance.

The IPA-Deakin SME Research Centre acknowledges that the federal government has already taken legislative initiatives that will greatly assist many entrepreneurs and start-up businesses that may fail at least once before becoming successful. In its *National Innovation and Science Agenda Report*[29], the government announced that it would reform insolvency laws "which currently put too much focus on penalising and stigmatising business failure". The government also recognises that some entrepreneurs may fail several times before they succeed, but they "will usually learn more from the failure than from the success". For these reasons, the government proposed reforms to insolvency laws that would:

- introduce a safe harbour for directors from personal liability from insolvent trading in certain circumstances (i.e. when a professional adviser is appointed to turn the business around)
- ban the use of *ipso facto* clauses in contracts, such that an agreement cannot be terminated purely on the basis of an insolvency event during a restructure

[29] Department of Industry, Innovation and Science (2015).

- reduce the *bankruptcy default* period from three years to one year, thus allowing entrepreneurs to return to their business activities much quicker.

It is pleasing to see that, on 11 September 2017, the *Treasuries Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017* passed through the Senate, bringing at least two of the above reforms closer to becoming law. The *safe harbour* exception for insolvent trading will commence when the bill receives royal assent, whereas the reforms for the *ipso facto* rights are expected to apply from July 2018. It is interesting to note that the safe harbour provisions will only apply where directors develop (or are in the process of developing) one or more courses of action that "are reasonably likely to provide a better outcome for the company" than would be the case if a liquidation or administration is immediately effected.

Two further points warrant attention. Firstly, directors will enter the safe harbour, and thus have an *exception* (i.e. not a *defence*) from insolvent trading liability, only when developing courses of action that are likely to provide **better outcomes for the company** – i.e. not the directors themselves. Secondly, what constitutes a **better outcome** for the company, versus outcomes from an insolvency/administration, will be a matter of much professional judgement, and will no doubt be tested in practice when the bill becomes operative.

As a final note, while the IPA-Deakin SME Research Centre continues to support legal reforms which can assist entrepreneurs and owners of start-ups, we also need to be cognisant that SMEs will often deal with third parties that may qualify for protection under the safe harbour provisions. Accordingly, given that the new laws do not apply retrospectively, contracts and arrangements after the Treasuries Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 becomes law will need to be carefully considered such that adequate protection provisions are in place and are not likely to be unenforceable due to the ipso facto reforms.

Principle 7 (OECD 2) – Strengthen SME access to traditional bank financing

We mentioned earlier that, despite problems in obtaining finance from banks, bank lending is still the most common form of financing for start-ups as well as established SMEs. However, bank lending practices appear to be changing globally and moving more toward asset-based financing for SMEs. While this may be good news for many SMEs, for businesses at the smaller end of the size scale there may be insufficient assets, or the appraisal of such assets might yield low values that are insufficient for collateral purposes.

One of the ways global finance think tanks suggest this problem can be overcome is to extend lending conditions to permit a broader range of assets for use as security for the loan. The focus on assets against which a loan may be obtained should be broadened so that 'movable' assets can become collateral for the loan.

One other area that may merit further consideration (although some may view it as contentious) is the use of intangibles assets as collateral. This may be relevant in the context of knowledge-based companies that have few ‘bricks and mortar’ assets to put up in exchange for access to funds.

The IPA-Deakin SME Research Centre, in principle, endorses the concept of including intangibles as a part of the asset mix for security purposes, as many firms now disclose intangible assets in their balance sheets as a significant component of total assets. This is not unreasonable as the world moves closer to all businesses becoming IT-dominated entities. Moreover, the valuation of intangibles using sophisticated finance techniques is gaining traction and has created an atmosphere of less uncertainty and greater reliability among lenders and regulators, although banking institutions continue to exercise caution and rely on prudential lending practices as well as comprehensive risk assessments.

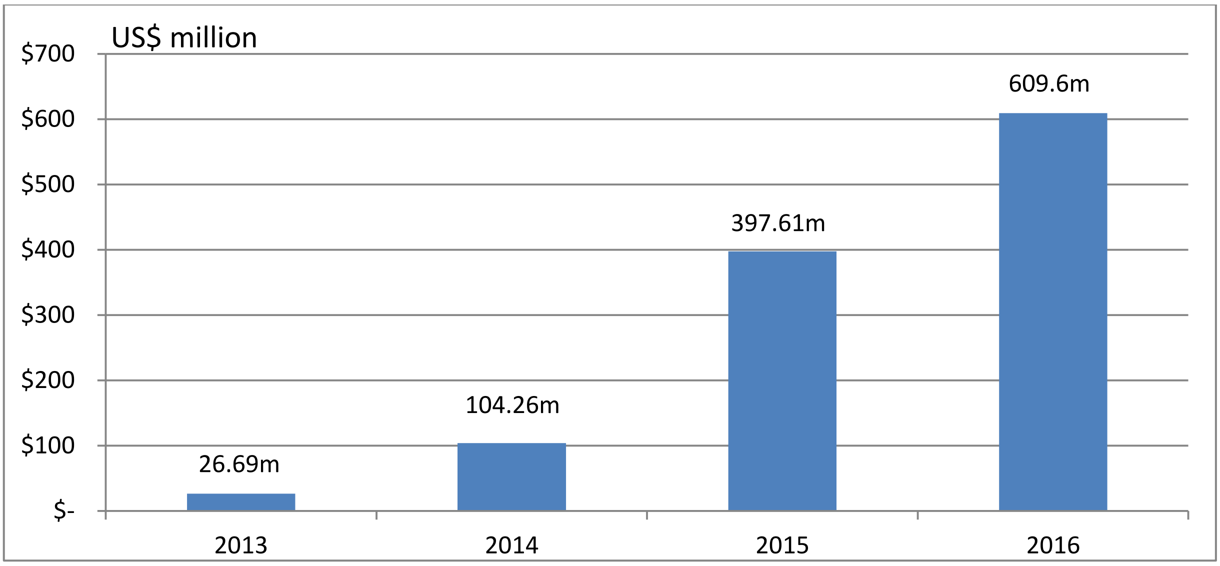
There may also be scope for the review of other aspects of traditional banking. This might include, among other things, a review of credit guarantees and the provision of credit insurance where relevant (discussed in more depth below).

Principle 8 (OECD 3) – Enable SMEs to access diverse non-traditional bank financing instruments and channel innovation

One policy area needing the attention of governments and other actors in the policy-making process is to support initiatives to further develop non-traditional financing options. While traditional lenders will still be critical, there is a need to consider the potential role of a broader group of investors in businesses.

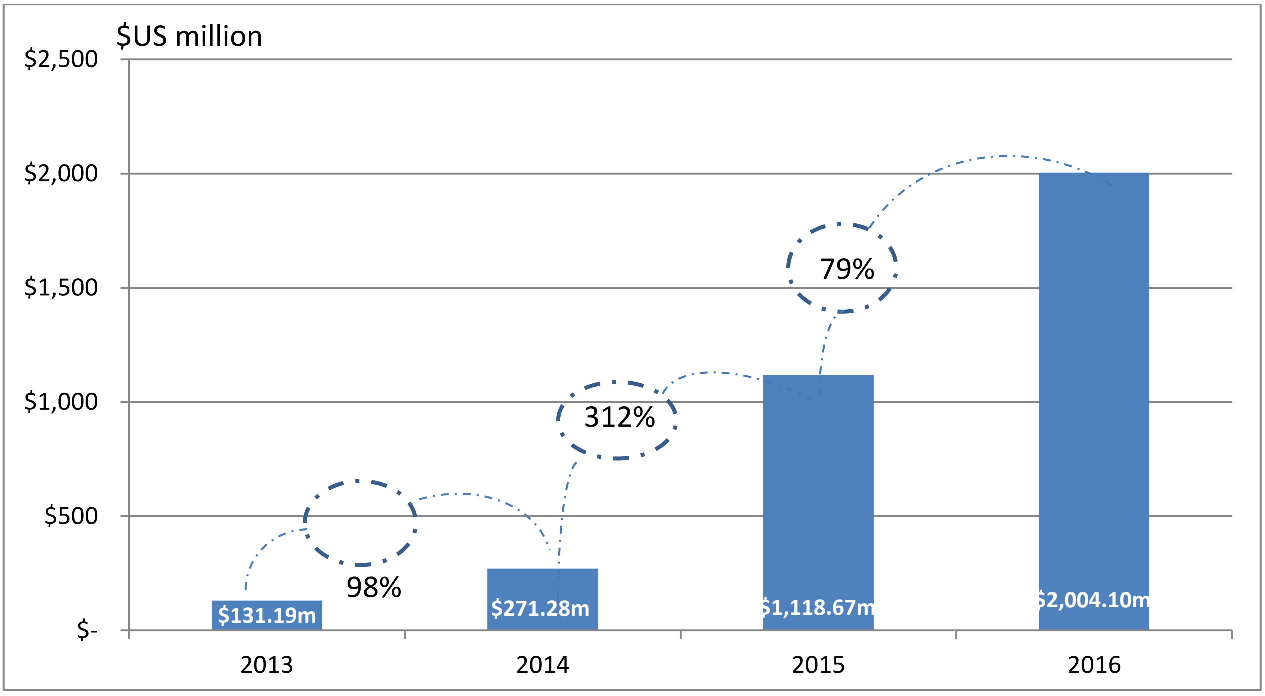
The G20 and OECD have noted that small business owners have, for decades, relied heavily on traditional sources of finance such as bank loans, overdrafts, credit lines and credit cards to enable them to start up and/or meet operating cash flow and investment needs. Some forms of finance, however, may not be suitable for those businesses that operate in newer and faster-growing industries. There may also be circumstances where substantial funds are required for specific projects, but finance might be difficult to obtain if there is an inability for a small business owner or their adviser to provide reliable revenue and profit forecasts for potential lenders. Given these inherent difficulties, new financing models have, perhaps by default, emerged to address the finance gap. Figure 4 and Figure 5 show an increasing reliance on alternative funding sources in Australia and neighbouring regions from 2013 to 2016.

Figure 4: Australia – total alternative finance market size 2013-2016 ($US Million)



Source: Cultivating Growth: The 2nd Asia Pacific Region Alternative Finance Industry Report, September 2017, University of Cambridge: Judge Business School, Monash University, and Tsinghua University in Collaboration with KPMG, CME Group Foundation, and HNA Capital.

Figure 5: Total Asia Pacific – alternative finance volume (excluding China) 2013-2016 ($US Million)



Source: Cultivating Growth: The 2nd Asia Pacific Region Alternative Finance Industry Report, September 2017, University of Cambridge: Judge Business School, Monash University, and Tsinghua University in Collaboration with KPMG, CME Group Foundation, and HNA Capital.

As the old adage goes, 'it takes two to tango' when considering financing options: i.e. lenders and applicants both need to assess the risks and payoffs. Small business owners need to decide what level of risk and accountability they are prepared to entertain. Low-risk financing options might appeal to some entrepreneurs, but banks and similar institutions may find it difficult to justify lending to business owners that are unable to provide an indication of profitability or provide sustainable income streams as evidence of their ability to service a loan. At the other extreme, there are high-risk options where an individual or entity chooses to buy a share of a business or provide personal funds as a way of establishing a new business.

International organisations such as the G20 and the OECD, among others, have expended significant resources in considering the impact of possible sources of finance on the SME sector globally. The OECD provides a useful list of alternative sources of financing for small-to-medium enterprises (as shown in Table 3) and the broad category of possible sources of finance and their relative risk profiles (according to the OECD), as shown below:

- Asset-based finance (low risk/return)
- Alternative debt (low risk/return)
- 'Hybrid' instruments (medium risk/return)
- Equity instruments (high risk/return).

Table 3: Alternative financing instruments

<table>
<tr><th colspan="4">Alternative financing instruments</th></tr>
<tr><th colspan="2">Low risk/return</th><th>Medium risk/return</th><th>High risk/return</th></tr>
<tr><th>Asset-based finance</th><th>Alternative debt</th><th>'Hybrid' instruments</th><th>Equity instruments</th></tr>
<tr>
<td>• Asset-based lending
• Factoring
• Purchase order finance
• Warehouse receipts
• Leasing</td>
<td>• Corporate bonds
• Securitised debt
• Covered bonds
• Private placements
• Crowdfunding (debt)</td>
<td>• Subordinated loans/bonds
• Silent participations
• Participating loans
• Profit participation rights
• Convertible bonds
• Bonds with warrants
• Mezzanine finance</td>
<td>• Private equity
• Venture capital
• Business angels
• Specialised platforms for public listing of SMEs
• Crowdfunding (equity)</td>
</tr>
</table>

Source: OECD (2015a), New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD Publishing: Paris.

Alternative financing instruments

To provide readers with a better understanding of some of the above financing approaches for SMEs, we have briefly outlined their major features below.

Asset-based finance

Asset-based finance, which encompasses asset-based lending, factoring and leasing, is not based on the credit standing of a small business, but relates to the value of assets owned by the business or the personal assets of the owner. The owner of a small business would be able to access cash more readily and under terms that are more generous than the traditional bank loan. For example, on the strength of the valuation appraisal of the assets, a small business owner may be able to access finance to meet working capital needs even though the business does not have a credit or trading history.

An advantage in an asset-based financing arrangement can be the ability to access additional funds as advances that are repaid back to the lender. The small business owner may be able to secure additional funds that could be borrowed against other assets owned by the business. A disadvantage in using this kind of financing is that there may be higher costs and complex procedures, as well as serious limits to the actual size of the loan.

Principle 11 (OECD 11) – Monitor and evaluate public programs to enhance SME finance

All stakeholders involved in financing SMEs should ensure that monitoring and evaluation occurs on a regular basis so the effectiveness of a scheme is tested. This is necessary to ensure decisions made about continuing, revising or discontinuing an SME financing program are made with appropriate evidence. The OECD observes that ex ante and ex post evaluation must be performed in accordance with "clearly defined, rigorous and measurable policy objectives and impacts". It says that such research into programs must be conducted with the assistance of financial institutions, small business representatives and any other stakeholders that may be relevant to the program under review.

Evidence from research conducted into SME financing programs and their impact may be used to shape government policies. Australian government bodies such as the Productivity Commission[30], for example, will review marketplace conditions to determine whether there are any barriers that make it difficult for SMEs to access finance. A September 2015 report into the set-up, transfer and closure of businesses found that there were challenges for SMEs seeking access to finance. The Australian Small Business Commissioner[31] observed that

[30] Productivity Commission (2015).
[31] Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2016).

access to finance still rated as a concern for many small businesses because non-bank financing streams such as finance companies had exited the market place as a result of the Global Financial Crisis (GFC) and the immaturity of alternative financing options such as crowdfunding and venture capital.

It should be noted that since the Productivity Commission report was tabled, the federal government has introduced the option of crowdsourced funding for public and proprietary companies as a way for entities to access finance. The 2015 report noted that the number-one barrier to innovation is access to finance and that access to finance was the third largest barrier to general business activity. Reports such as this will be used to assist in reviewing laws and regulations i to determine whether the federal or state parliaments can remove legal barriers limiting the variety of ways small businesses can obtain finance for their enterprise while still maintaining appropriate restraints to protect the investing public.

Knowledge obtained from research or inquiries into the finance needs of small businesses may also be used internationally as a part of information sharing that is encouraged by the OECD. The G20 and the OECD are two forums through which knowledge about small business finance trends and methods is able to be disseminated. Australian representatives to the OECD are able to share the research done by agencies such as the Australian Bureau of Statistics or the Productivity Commission to enhance the understanding of the experience of small businesses in a specific jurisdiction. This may encourage the government in a country with an underdeveloped economy to adopt similar measures to create greater financing opportunities for small businesses in their own economies.

There are other non-government channels for sharing results from research and inquiries. The professional accounting bodies across the globe are able to share the experience they have in operating within a particular financial market. That sharing of knowledge can occur in many different ways, such as through publications and online training that is accessible to practitioners in other countries. The sharing of ways in which finance systems could be improved can also be done through the various peak bodies for the accounting profession such as the International Federation of Accountants (IFAC) and the Confederation of Asian and Pacific Accountants (CAPA). Each of these organisations has committees that deal with a variety of issues facing small businesses.

The critical issues include methods of financing small businesses. Accounting bodies from countries with less sophisticated financial markets may be able to leverage this knowledge to advocate for change in the laws of their country, with the ultimate goal of improving the access to finance for small business owners.

The IPA-Deakin SME Research Centre notes that the federal government already has an extensive consultation process with various stakeholders where SME matters are concerned. The Centre encourages the federal government to continue maintaining this high level of engagement with the SME sector through the following mechanisms:

- The federal government should periodically review laws and regulations that impact SME financing to ensure they meet or exceed the benchmark set by the OECD in its SME financing principles
- The federal government should continue (and enhance wherever possible) its outreach to the SME sector on matters relating to access to finance and onerous regulations
- Financial institutions should be encouraged to review their financial products periodically to ensure they are providing a variety of financing solutions to SMEs for whom the traditional bank loan may be ineffective
- Tax deductions for undertaking courses in small business management provided by reputable registered training organisations should be considered to encourage SME operators to improve their knowledge in business management and finance.

Government initiatives supporting SMEs[32]

A number of government initiatives specific to SMEs and entrepreneurs are currently available and worthy of a brief mention here. The IPA-Deakin SME Research Centre supports these initiatives, which we believe provide great support for the SME community. As a means of providing further coverage and support for the SME community, a brief dialogue of the initiatives relevant to SMEs is provided below.

1.
2. Accelerating commercialisation – helping small and medium businesses, entrepreneurs and researchers to commercialise novel products, services and processes.
3. Business management – with experienced business advisers and facilitators reviewing business operations, including business direction, strategy, growth opportunities and supply chain. They provide a report with strategies for business improvement and work with SME managers to make them happen.
4. Incubator support – assisting new and existing incubators to improve the prospects of Australian start-ups achieving commercial success in international markets, through helping them to develop their business capabilities.
5. Innovation connections – with experienced innovation facilitators working with SMEs to identify knowledge gaps that are preventing business growth. The outcome is an innovation facilitation report, providing practical support for businesses, including:
    - advice from people with relevant private sector experience
    - co-funded grants to commercialise new products, processes and services
    - funding to take advantage of growth opportunities
    - connection and collaboration opportunities.

[32] For more information, see Department of Industry, Innovation and Science (2017).

Table 4a: SME and small business participation trends (value of contracts)*

Financial year	SME including small business		SME excluding small business		Small business		Other		Total	
	Value $m		Value $m		Value $m		Value $m		Value $m	
2016-17	12,309	25.99%	6,500	13.73%	5,809	12.27%	35,046	74.01%	47,355	100%
2015-16	13,680	24.04%	8,134	14.29%	5,546	9.74%	43,232	75.96%	56,912	100%
2014-15	16,716	28.12%	10,910	18.35%	5,806	9.77%	42,731	71.88%	59,447	100%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>. Accessed 20 February 2018.

Table 5b: SME and small business participation trends (quantity of contracts)*

Financial year	SME including small business		SME excluding small business		Small business		Others		Total	
	Number of contracts		Number of contracts		Number of contracts		Number of contracts		Number of contracts	
2016-17	38,649	60.30%	17,338	27.05%	21,311	33.25%	25,443	39.70%	64,092	100%
2015-16	42,737	60.76%	19,854	28.23%	22,883	32.53%	27,601	39.24%	70,338	100%
2014-15	41,151	59.44%	17,611	25.44%	23,540	34.00%	28,085	40.56%	69,236	100%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>. Accessed 20 February 2018.

*Note: An SME is defined as a business which has less than 200 employees and operates independently of any parent organisation for taxation arrangements. A small business is defined as a business with fewer than 20 employees. Small Business is a subset of SME. Note that the government's target for SME participation by contract value is 10% and has been consistently well above 20%. SME participation in 2016-17 was 26%. It was 24% in 2015-16, 28% in 2014-15, 34% in 2013-14 and 32% in 2012-13.
43% goods and decreasing to 57% services for both the 2015-16 and 2016-17 periods.

Principle 12 – Develop and promote government-backed credit guarantee schemes

The IPA-Deakin SME Research Centre articulated, in WP1, the need to have a government-backed credit (loan) guarantee scheme (CGS) and the IPA, as joint partner of the IPA-Deakin Research Centre, has in its capacity as a peak professional body continued to pursue this initiative through advocacy, publicity in its journals and, more recently, with detailed commentary in their 2018-19 pre-budget submission.

Given the potentially significant boost to the economy, particularly through economic additionality via a government-backed source of funding for SMEs, we reiterate, below, the major points raised in the IPA 2018 pre-budget submission.

IPA 2018-19 pre-budget submission: credit (loan) guarantee schemes

The rationale for public intervention to improve SMEs' ability to access private financing is twofold. First, as argued in previous sections of this paper, the spill-over hypothesis posits that SMEs are able to generate positive externalities by creating new jobs, new ideas and new abilities that other industries and the economy as a whole may enjoy. The second argument for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard.[33]
A few key points are worthy of mention here:

- The focus of investment in Australia has shifted from investments in new productive capacity and efficiency to a more basic survival and liquidity dynamic, necessitating greater expenditures for continuity and going concern.
- By comparable international standards, the cost of debt in Australia is high.
- Australian lending banks, in complying with the Basel III obligations, are cautious in their general lending policies (compared with offshore jurisdictions) and risk-adjusted lending is not the norm.
- The IPA in its capacity as a peak professional body, the members of which deal with SMEs on a daily basis, recommends that a credit guarantee scheme is justified, albeit on a modest scale, for a trial period.
- External equity is of particular relevance for those high-growth/high-potential, young businesses, where the current revenue capability cannot sustain a guaranteed payment of loan interest, thereby possibly ruling out debt finance.
- There is a real danger that equity market pump-priming by the state translates into a permanent arrangement, with private investors happy to leave the onus and challenge of early-stage investing to the government. Legal (statutory) rules to prevent the government from becoming a cornerstone investor partly address this concern.
- Governments with a strong commitment to economic growth via R&D investment, facilitating greater enterprise and innovation activity, are faced with a direct choice. They must find a means to ensure that early-stage venture capital (VC) finance

[33] Recall from our previous discussion, generally, that there is less public information available for small-to-medium enterprises as compared with larger, more established businesses. This is particularly the case for start-ups and younger enterprises with either no or little trading history. Lack of credible information increases uncertainty for prospective lenders, resulting in a perception of a higher risk profile. In turn, this could mean that a loan will be declined or, if granted, the lender will compensate for the risk through higher interest rates, greater collateral requirements, a requirement for loan protection insurance and/or a combination of all three measures.

remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology.

The important public policy question is whether or not constrained businesses are of poor quality, and hence too risky to invest in, or whether they are constrained for non-quality-based reasons such as lack of assets to place as security or lack of a sufficiently long track record. The former implies no role for public policy and is simply an indicator of the market operating efficiently and sorting out the 'good' from 'bad' propositions. The latter implies unfair rationing and a case can be made for public policy intervention to correct for a market failure.

The most widely used, and long-standing, public policy mechanism worldwide for supporting small firms is the (partial) credit guarantee scheme. Well-established examples of these schemes include the SBA 7(a) loan program in the United States (discussed further below) founded in 1953, the Canadian core guarantee program (CSBFP) founded in 1961, and the United Kingdom's Small Firm Loan Guarantee program, founded in 1981. A World Bank guarantee scheme survey by Beck, Klapper and Mendoza[34] identified loan guarantee programs in a total of 46 different countries across the world, including France, Germany, Sweden, India, Korea, Indonesia and Macedonia. In this regard, we note with interest that Australia is unique in the developed world in that it has no credit guarantee scheme in place.

Critical indicators of the need for credit guarantee programs

Having considered why credit may be rationed among smaller firms, and which firms are most likely to face severe problems in accessing debt finance from conventional sources, we now outline the critical indicators that policy-makers in Australia might consider when assessing the specific need for policy intervention in the form of credit guarantee type programs. These include:

- a highly concentrated banking sector (few large banks)[35]
- fewer dense local branch networks and a general lack of relationship banking
- low levels of housing or general (tangible) asset ownership
- most commercial loans require assets to be placed as security
- falling or stable asset values
- a diverse entrepreneurial and latent entrepreneur population (poor as well as rich potential entrepreneurs)
- access to loans is conditional on criteria not related to the quality of the entrepreneur or their investment proposal (e.g. collateral availability)

[34] Beck, Klapper and Mendoza (2008).
[35] Institute of Public Accountants (2018).

- the spread of interest rates on bank loans between large companies and SMEs is broad (around 2% in Australia, compared with a world median of 0.96%)[36] indicating rationing is favoured over risk-adjusted lending
- there is substantial diversity in the relative quality of lending institutions.

The case for an Australian credit guarantee scheme

The evidence is broadly supportive of the use of financial engineering instruments to correct for (the lack of) collateral issues in debt markets and, to a lesser degree, lack of a track record. Credit guarantee schemes have the advantage of being simple to design and administer, and typically require that investment appraisal is conducted on a commercial basis, thus minimising deadweight. Instruments of this type are most effective when the entrepreneurial population is more widely distributed than wealth throughout the general population. This gives credit guarantee schemes the potential to have disproportionately high and positive effects in countries and regions where:

(a) collateral-based lending is the norm
(b) a significant proportion of the entrepreneurial population is not asset-rich.
As a tool for promoting local economic development, credit guarantee schemes have been shown to be relatively successful as a means of public policy intervention.[37]

To a degree, the evidence in the academic literature reports that the high costs of debt, low interest margins and cautious lending are all consistent with credit rationing theories limiting the flow of loans to entrepreneurs. That is, margins imply relatively low-risk lending and a backward-bending loan supply curve, while riskier loans are choked off as they would attract a higher interest rate margin and raise the default rate above the banks' expected profit maximising level.

Models of credit guarantee schemes

The OECD discussion paper cited above also identifies four types of CGS[38]:

1. **Public guarantee schemes:** where governments bodies assume part of the risk. Due to the involvement of public funds, this is the safest scheme for commercial lenders.
2. **Corporate guarantee schemes**: where, typically, banks create guarantee schemes which charge borrowers a premium of 1-2% of loan value to provide the guarantee. The banks creating the schemes have experience in credit provision and these schemes tend to be successful.

[36] OECD (2018).
[37] OECD (2009); Cowling (2007); Arping, Morrison and Lóránth (2008); Boocock and Shariff (2005); Bennett, Doran and Billington (2005); Levitsky (1997a); Levitsky (1997b); Roper (2009); Wilcox and Yasuda (2008).
[38] OECD (2009); Cowling (2007); Arping, Morrison and Lóránth (2008); Boocock and Shariff (2005); Bennett, Doran and Billington (2005); Levitsky (1997a); Levitsky (1997b); Roper (2009); Wilcox and Yasuda (2008).

3. **International schemes:** created and managed by bilateral or multilateral government or NGO initiatives (e.g. the ILO, UNIDO or the European Investment Fund). One benefit of these schemes is that, as well as providing the guarantee, they also provide technical expertise.
4. **Mutual guarantee schemes***:* where borrowers from an association, typically based on similar types of firms, fund guarantees by pooling membership subscriptions with or without government support. Members provide support to each other and use peer pressure to minimise the number of defaults.

Designing a credit guarantee scheme

One of the key success factors of credit guarantee programs throughout the world is the simplicity of their basic parameters and the general level of flexibility that these parameters allow policy-makers to reshape or refocus programs. The fact that commercial banks conduct due diligence (in most but not all cases) effectively transfers some of the downside risk back to banks, although the government clearly bears most of the default risk. Important in the Australian context is that banks might become more willing to expand the supply of loans significantly when a large share of the outstanding loan is guaranteed and the pool of loans still does not suffer from excessively high default rates.

As a guideline, the typical range across these core parameters for established credit guarantee schemes are as follows:

- Guarantee: 65% to 85%
- Interest rate premium: 0.5% to 2.5%
- Loan size: minimum A$8,000, maximum A$500,000
- Loan term: 1 to10 years
- Arrangement fee: 0.25% to 3.0% of the total loan value.

We conclude that there is a case for the design and implementation of a credit guarantee program in Australia to correct for the specific problems of smaller firms being unable to finance new investment opportunities through normal commercial bank channels on affordable and 'reasonable' terms. But the specific scale of potential program demand needs to be established in a detailed feasibility study, as this determines the scale of the initial and ongoing demands on the government.

Recommendations

- The federal government must review its current policy settings for SME finance to ensure it is following world's best practice, as specified by the G20 and OECD.
- Given the importance of SMEs as significant contributors to (and drivers) of GDP, the federal government should provide appropriate incentives that encourage financial institutions to urgently re-examine their finance offerings for SMEs. These should include the provision of varying options allowing SMEs access to funding for starting up a business and for working capital. While the primary role of financial institutions is to generate returns for shareholders, given that there is significant industry concentration in the banking industry in Australia, banks have a dominant role in financial markets impacting all businesses. Accordingly, the IPA-Deakin SME Research Centre is of the view that banks and similar institutions have wider obligations towards ensuring the financial health of the business community.
- Loan guarantee schemes must urgently be initiated for Australia to be in step with similar initiatives in offshore jurisdictions.
- Vocational education courses must receive priority funding from the federal government to enhance SME owners' financial literacy. The IPA-Deakin SME Research Centre also supports practical education in areas encompassing business strategy and management, which should also form part of the educational offerings.
- Incentives for further financial literacy and SME business management education, such as tax deductibility for educational costs, should be offered to SME owners via the tax system. Registered Training Organisations (RTOs) could partake in government incentives and play a more active role in encouraging SME operators to improve their knowledge in business management and finance.
- The federal government should seek to fund research initiatives to support the work of the OECD in developing a generally-accepted definition of SMEs.
- The federal government should support initiatives for the introduction of a new bank that services the specific financing needs of the SME sector.