Submission To The Financial System Inquiry By Alan Cullen, Executive Chairman Of Thinkbank Pty. Ltd.

Introduction.

Small and medium sized enterprises (SMEs) are the Cinderella of Deregulation. Everyone else has been to the Ball. The humblest household has access to the international capital markets through mortgage securitisation but high performing small or medium sized enterprises remain in the pattern of finance that applied in the regulated era. The source of equity capital is mainly found in the informal markets. Banks are the major source of debt finance, with traditional products predominating. This illustrates the fact that deregulation coupled with technological advance has not yet delivered the outcome of a seamless, deep and efficient financial market where there are no pockets of disadvantage.

This submission concentrates first on the special case of access by SMEs to the financial system. If then deals with some general systemic issues which are raised by the operation of the market in relation to SMEs.

The current position of SMEs.

<u>Performance</u>

SMEs in Australia exhibit (as a group) superior financial performance and attributes to larger businesses (as a group). Appendices 1,2 and 3 show that on measures of return on equity, margins and free cash flow to service interest expense SMEs in most industry sectors have outperformed large business. The rate of failure of SMEs has not been quantified but it is clear that many of these businesses which ceased to trade do so for reasons other than financial failure. Appendix 4 adjusts the financial measures for an assumed failure rate of 20 percent. Even with this adjustment a portfolio investment over the period would have produced superior returns from investment in SMEs.

<u>Access to the equities market</u>

About 1200 companies are listed on the Australian stock Exchange. About 50 Australian companies are rated by Moody's. It is usual practice for institutional investors to confine themselves to companies which are either listed or rated. Furthermore, even smaller listed companies find that investment size is too small to interest the institutions which have no inclination to depart from customary practice of concentrating on larger companies. Factors which are cited by the institutions include the relative cost of investment research and decision making, the small size of each investment and a fear that the market for these shares is illiquid.

It is fair to record that some institutions have established portfolios in small cap stocks. However, at best, total institutional investment in SMEs probably does not exceed $2 billion.

Appendix 5 shows the cost of listing on the Australian Stock Exchange. SMEs can expect to pay up to 5% of the amount sought for placement and underwriting by a broker. In addition, there are significant legal processes and costs.

The minimum cost of issuing a public prospectus is $75,000 to $100,000 mainly because of the legal fees associated with compliance with the Corporations Law. Obviously, this presents a substantial impediment to raising funds either on the Exchange or on an over the counter basis, for small fund raisings. Even where the size of the fund raising makes this an appropriate means, many SMEs which would benefit find the whole process daunting (particularly the legal requirements).

The cost and process of rating by established agencies is likewise inhibiting for many SMEs.

Venture and capital development companies have had a mixed history. They have been able to service only a very small proportion of SMEs. Their approach is very expert labour intensive and consequently is expensive for SMEs. The annual management fee is typically two percent of the amount raised and the minimum raising $I million.

Private investment sources are not well developed in Australia. Investment advisers and security dealers are inhibited by lack of information and by fiduciary and other legal obligations.

With a lack of a private investment culture, the efforts to establish a business angels program (such as the Business Finance Support program of the Victorian Chamber of Commerce and Industry), as one of the delivery mechanisms, are in their infancy and vulnerable.

Hence, SMEs must often rely on family and friends and retained earnings to provide the necessary equity. Often debt is used where equity would be more appropriate. It would be desirable to consider how a private investment culture could be fostered in Australia since it often transfers skills as well as money.

In Australia, we are reaching a period of generational change when the market may not be accommodating to the succession needs of SMEs.

Debt Finance

Raising debt finance through debentures is subject to the problems and cost discussed above. As far as the banks are concerned, Appendix 6 shows the interest rates from the Reserve Bank bulletin for commercial bills, housing loans and small business indicator rates (plus 2% to approximate median market rates). The commercial bills rate can be taken as a proxy for cost of funds and also as the indicator rate for corporate (very large businesses). The difference between the rates for corporate and those for the business indicator rates is very large having regard to financial performance. What it reflects is recognition and acceptance by the global financial markets of the securities of those corporates. This effect can be seen in the housing market where securitisation has produced a marked reduction in spread although the risk profile of the underlying assets has not changed. The ability to create tradable securities for SMEs could have a similar consequence. However, the distinction from the mortgage market is that the information content of the SME securities is more important than the underlying assets. The ability to generate an active market will depend essentially on the creation of cost effective, quality market information. Given the problem of capturing and processing quality information on SMEs, it is difficult for the banks with their current expert systems, infrastructure costs and case by case approach to alter the current pattern substantially. An improvement in information quality and the cost of processing is essential to enabling banks to improve risk assessment and reduce non interest costs thus enabling reductions in interest rates and security requirements. In an active market for SMEs' securities banks would be able to use securitisation and derivatives to extend their service to SMEs while managing their risk and capital exposures.

The Australian Securities Commission.

The Australian Securities Commission was established as a regulatory agency and thus its focus has been on compliance with the legislation which it administers. It has also been a net revenue raiser for the Government. As a result, the ASC has not been able to make optimal use of its resources to make the market work better. For example, the SEC in the USA provides free access to its data base over the Internet in order to achieve the objective of keeping the market fully informed. (refer Internet http://www.sec.gov/edaux/wedgov.htm) and has been given much more flexibility under its legislation to meet the fundraising needs of small businesses.

In Australia, the Corporations Law simplification program has recently removed information requirements essential to an informed market. 98% of Australian companies will be financially invisible to the market because they are not obliged to lodge their accounts in the public domain. This change was made without evaluating the widespread use of the information through the established credit bureaus and by accounting firms and other inquirers.

The exhaustive prospectus disclosure requirements are badly suited to the actual needs of the market when judged by the criteria of actual use of the information and production at reasonable cost. The narrowness of the excluded market concept produces excessive regulation

Creating an efficient financial market for SMEs.

Four elements are necessary to transform the current market into one which uses all of the potential that deregulation and technological progress has made possible. Such a market would see securities of SMEs acceptable within global markets, information of depth and quality available to the market and extensive use of derivatives and securitisation to deal with issues such as control, profit share and credit risk..

1. Information

The basis upon which any market works depends on the quality, cost and delivery of information. Many SMEs do not yet appreciate the market value of quality information and the market has not delivered mechanisms to capture, process and deliver that information widely when produced Consequently, the competitive functioning of the market is impaired and prices and conditions reflect the inability to gauge risk in the absence of information. The Government needs to direct its attention to the means by which the objective of enabling the market to produce the requisite information flows can be achieved.

Starting at the level of fundamental information, the ASC has not been used appropriately as an information resource. The financial information of the ASC has never been examined on receipt and is not stored on a relational data base. The use of ASC information is priced to recover twice the cost of administering the ASC. From the point of view of users, the financial data base prevents active use because of its storage and the price of access. The cost of reviewing the company data base for five years in order to identify suitable SMEs, analyze them and compare SMEs with others would be in excess of $100 million.

The decision to reduce the requirement for financial information to include only about 20,000 companies is contrary to the interests of SMEs for the reasons mentioned above and because the same information will be demanded by banks and other creditors so that it will have to be supplied several times,

The ASC, the ATO and the ABS collect overlapping information from SMEs. There is a strong case for the separation of the information collecting role of the Government from its administrative tasks and to charge the information collecting agency with a duty to examine the alternative uses of the information where value can be added without infringing privacy.

From a public policy perspective, a company which has the benefit of limited liability should be identified and the directors and managers and financial capacity to enter into contracts be known (i.e. at least the annual accounts).

The task of processing and disseminating the multiple sources of public and private information should be a private sector task in Australia. As in the Government and corporate securities markets there is a need for third party, independent analysis and rating to support an active market. The Newinvest project of Thinkbank is one such project. With the co-operation of the ASC and the Credit Reference Association of Australia Ltd. it aims to build the premier data base on SMEs using the available technological tools to the maximum to bring down costs. The success of credit scoring in Australia has shown convincingly in consumer markets how technology and neural systems aligned to large populations can enhance efficiency in the credit process. In France, the Banque de France has over 20 years developed and made available to banks and other lenders ratings of 2.3 million enterprises and their managers and directors. The banks and other lenders make more than 1 million inquiries each month.

2. Regulation

The nature of the statutory requirements for a prospectus have to be re-examined. For small capital raisings the compliance costs are out of all proportion. There is merit in seeking to balance the class of investor to whom the invitation is to be addressed and the size of the raising with the complexity of compliance. Internet http://www.sec.gov/smbus/qasbsec.htm shows how active the Securities and Exchange

Commission has been in the USA in seeking to find ways of meeting the needs of small businesses and their investors. The Corporations Law Simplification Task Force proposal on Fundraising of November 1995 is inadequate in addressing the relevant needs. The restriction to 20 issues in a year and the minimum $500,000 to exclude persons will leave very many SMEs without relief and without justification for the arbitrary decisions made.

Section 66 of the Corporations act should be amended to allow securities dealers to invest as agents for their clients without restriction of number of clients before a prospectus is required, in addition to the ability to invest as a principal. These dealers have supervisory and fiduciary responsibilities which should provide adequate protection for their clients. Legislation should facilitate securitisation of securities of SMEs and associated derivatives.

3 Institutional structure

It is well known that investment managers are constrained by the preference of trustees for blue chip investments and by short term outcomes. Consequently, they have regard to the performance of their peers in the same restricted domain. Therefore, an industry focus on those measures which will enable adequate SME investment is vital. One of the issues, the measurement of performance, is critical to changing the outlook of the industry. A concerted effort to deal with this is essential, including the question of measurement in after tax terms.

The Australian Stock Exchange has not to date found a means of meeting the needs of SMEs and their investors. Whether under the aegis of the ASX or outside it there is a need for one or more formal markets for smaller companies. One of the proposed initiatives is Ausdaq, modeled on the successful NASDAQ in the USA. The Australian Government is to undertake a feasibility study for the establishment of an alternative market. It is certainly viable if the issues dealt with in this submission are addressed. However, even an alternative market will be very small relative to the informal over the counter market for companies for which the infrequency of transactions, their small size or restricted investor market makes listing on any market inappropriate or too costly. Hence, to service the needs of the vast majority of SMEs the Committee needs to focus on how to facilitate investment flows in the informal OTC market. This largely relates to the regulatory issues covering fundraising discussed above.

4. Liquidity

For a securities market the issue of liquidity is vital. The SME market has to deal with small amounts of stock. Volatility may be excessive relative to risk.. This means that every effort must be made to facilitate trade. The public policy issue concerning withdrawal from retail investment funds is similar to bank deposits. Government policy has encouraged individuals to place their retirement saving in funds which hold the promise of better returns if held over the longer term. If there is a run on these savings the Government should supply liquidity to the funds if it represents a systemic problem. This can be done by the purchase by the Reserve Bank of securities issued by SMEs from appropriate investment managers on a re purchase basis. This has the advantage over supplying liquidity indirectly through the banks of preventing a crisis of confidence in the underlying securities.

Broader issues.

Focus on the Markets not the Institutions

The aim of deregulation of the financial markets was to create a wide and deep competitive financial system fully integrated into the international financial markets. Considerable progress has been made. However, further development is required to improve the functioning of the market. The enormous benefits that have been brought to the corporate markets have yet to be realized in commercial and retail markets. For example, the use of derivatives to customize debt and equity raisings are rarely used for SMEs. When competition can reach into the elements of products then specialization will create maximum efficiency. Focus on the markets rather than the institutions should, therefore, be the direction of policy. The Reserve Bank has progressively moved in this direction reducing the distinction between banks and non banks that derives from Government support. The Reserve Bank shares regulation with the market through the private rating agencies and the stock market The notion of “bank” is increasingly a question of private rather than public franchises with the attributes of the bank applied to a wide range of financial services, subsidiaries and trusts. In this context, it is timely to review the depositor protection policy. Australia made the right decision to avoid depositor insurance which only creates a private regulator with its own risk profile. Public policy should create a “safe haven” for small savers in a variety of instruments. Given the extent to which retirement savings are being directed into equities and are held in trusts this needs to be included in the scope of that policy. Tentative steps have been made in this direction by allowing banks to invest in equities up to a limited proportion of their capital. This creates the possibility of channeling more savings into SMEs. The system under which depositors in banks in Australia without regard to size of deposit are given preference over the other creditors and upon which regulation of them is predicated is outmoded. The current system delivers uneven protection to small savers being strictly tied to a particular form of saving, and excessive regulation to the banks. The emphasis on the market in this proposal suggests that a super regulator would be a natural consequence but choosing the migration path is difficult since there are a number of fundamental policy issues relating to the operation of the market which need to be settled before such a decision would convey a benefit. It is difficult to see the benefit unless prudential regulation is applied generically instead of by reference to institutional type. How far can Australia depart from the special treatment of banks internationally by central banks and the international commercial relationships between banks which depend upon their special relationship with the central banks? The supervision of the payments system has special regulatory consequences. How wide is direct access going to be? The long history of safety for bank depositors is embedded in the community’s consciousness and the ability to obtain a bank license is now open. How will a significant shift in policy be managed with the understanding and acceptance of the community?

Management of Market Risk in Securities Trading

The key issue in financial markets is the management of risk. The tools are available to customize risk. The decision to implement RTGS removes the risk of a failure of a payment but does not extinguish credit risks associated with DvP where delivery and payment are not simultaneous. The Government should urgently ensure that there is legislative backing for netting of transactions effective against third parties in relation to securities dealings. This would enable market makers and other volume traders in SMEs' securities to manage their exposures better.

Liquidity and Systemic Risk

The Reserve Bank is concerned to deal with systemic risk in financial markets. In this respect collapses of confidence in securities markets due to factors which do not reflect the fundamentals are increasingly relevant. SMEs are particularly vulnerable and market failure can be catastrophic for long term confidence in their securities which is the position in Australia today. The Reserve should be prepared to purchase company securities from appropriate holders on a repurchase basis in conditions of systemic crisis.

Recommendations:

1. The conditions in financial markets for SMEs should be regarded as market failure. A concerted effort needs to be made to deal with the information, regulatory, institutional and liquidity aspects in a comprehensive fashion to resolve it.
2. The ASC should be given the duty to facilitate an active market in SME securities.
3. Companies should be required to lodge their annual accounts with the ASC with auditing to be required of those larger companies required to do so under the present law.
4. The accounts should be examined and placed on a relational data base (this could be outsourced).
5. The fee for access to ASC data should be removed or reduced. Any fee structure should have regard to realistic pricing for different search needs.
6. The information gathering of the ASC, the ATO and the ABS should be rationalised with a view to more efficiency and cost reduction, and thought be given to how that information can be used to benefit the functioning of the market.
7. The prohibitive costs of the prospectus philosophy for SMEs should be recognised. Changes to the Corporations Law which create more balanced solutions should be adopted. This includes but is not restricted to the notion of professional investor and size of investment. Section 66 of the Corporations Law should be amended to allow licensed securities dealers to be exempt dealers when acting as an agent.
8. Private information flows which aid the market should be facilitated, including the analysis and rating of SMEs.
9. The formation of alternative markets for SMEs should be facilitated including exchanges and over the counter markets.
10. The measurement of investment fund performance and other factors inhibiting substantial investment in SMEs should be addressed in conjunction with the investment funds industry.

11. The means of fostering a private investment culture in Australia especially where this encompasses the transfer of skills should be examined.
12. The focus of prudential regulation should be to provide a “safe haven” for small savers (who want that protection at its commercial price) and to manage systemic risk. This implies broadening the range of instruments in which providers of “safe haven” accounts can invest and enabling those institutions which can met the regulatory requirements applying to those accounts to offer them.
13. The law should be amended to ensure that netting of transfers of securities is effective against third parties.
14. The Reserve Bank should be prepared to purchase the securities of SMEs on a repurchase basis directly from investment institutions at times of systemic crisis likely to damage confidence in the SME sector.

Appendix 1

Average Financial Ratios 1990/91-1993/94 for Large Businesses and Small and Medium Sized Enterprises (SME)

	Before tax ROE Large	Before tax ROE SME	Profit Margins Large	Profit Margins SME	Free cash flow/ Interest expense Large	Free cash flow/ interest expense SME
Agriculture		3		13		2
Mining	16	81	16	20	3	7
Manufacturing	16	32	6	7	3	4
Electricity, etc.	5	10	10	12	1	1
Construction	24	45	4	5	3	2
Wholesale	11	20	2	2	1	2
Retail	18	29	2	3	2	2
Accommodation	-7	12	-3	4	-1	1
Transport	3	32	2	6	0	2
Communication	18	-46	15	-3	2	2
Finance	10	11	23	16	2	2
Property	19	18	6	7	1	3
Community services	9	23	6	13	0	4
Cultural services	25	28	15	10	4	3
Personal services	14	7	10	7	3	3

Source: ABS Catalogue 8140.0 1993-94

Appendix 2
Return on Equity (Net Worth) before Tax: Large Businesses

ROE Large %	1990-91	1991-92	1992-93	1993-94	Gross Product $million	% Total Gross Product
Agriculture						
Mining	17.1	12.1	17.3	15.9	13971	12.4
Manufacturing	16.3	12.7	15.9	18.4	34923	31.1
Electricity, etc.	4.2	5	5	6.4	13361	11.9
Construction	34.8	12.1	15	34.9	2905	2.6
Wholesale	18.5	2.3	8.9	12.5	6847	6.1
Retail	10.1	15.2	27.6	18.3	7373	6.6
Accommodation	-5.4	-7.8	-8.2	-6.2	2125	1.9
Transport	2.3	0.8	0	8.8	10670	9.5
Communication	18	20.6	16	18.6	10764	9.6
Finance	10.2	8.2	9.7	10	-2637	-2.3
Property	18.2	11.7	23.6	23.6	5059	4.5
Community services	7.3	7	7.6	14.3	3538	3.2
Cultural services	35.3	16.7	28.7	20.4	2502	2.2
Personal services	15.3	14	15.9	9.8	899	0.8
Total					112300	100.0

Source: ABS Catalogue 8140.0 1993-94

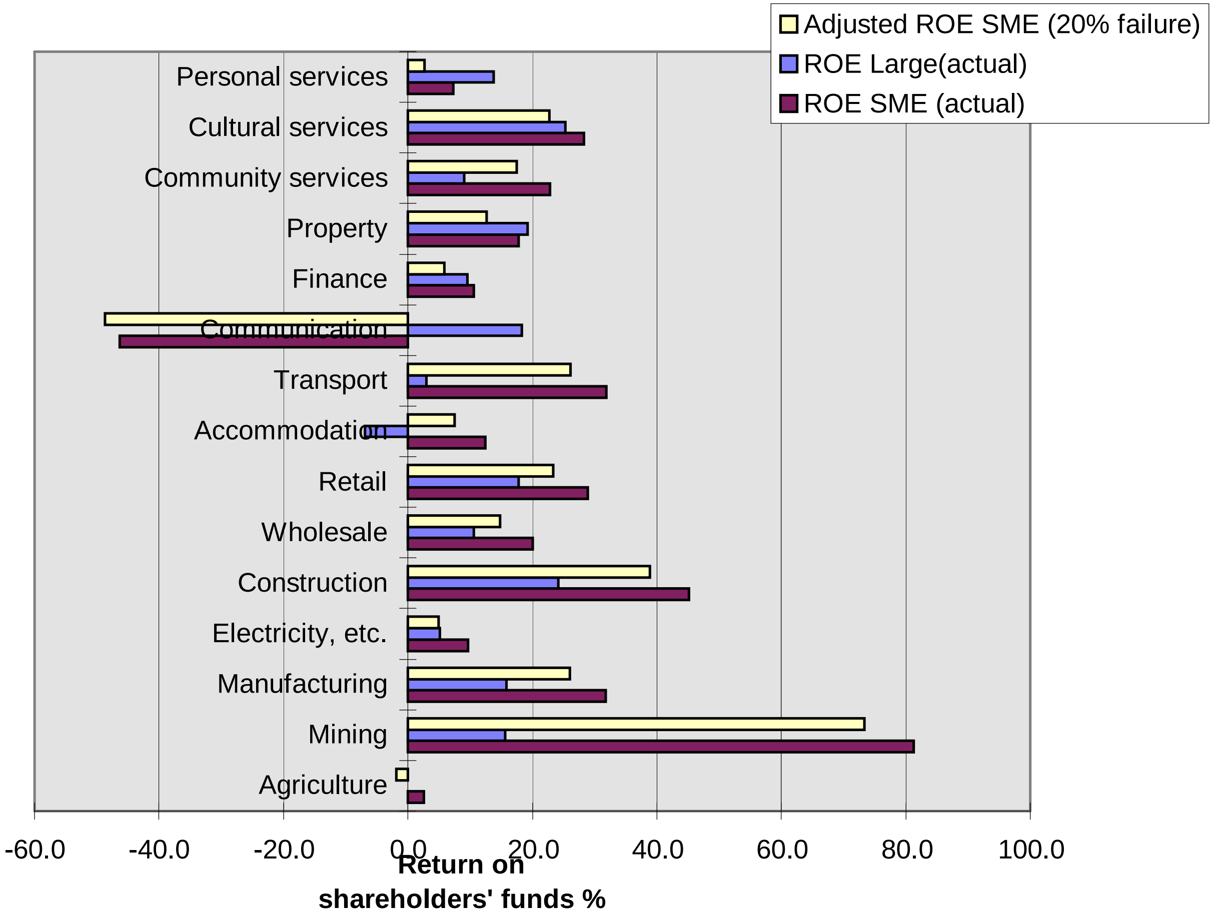
Appendix 3

Return on Equity (Net Worth) before Tax: Small and Medium Sized Enterprises

ROE SME %	1990-91	1991-92	1992-93	1993-94	Gross Product $million	% Total Gross Product
Agriculture	1.5	2.5	3.7	4.6	1432	1.4
Mining	159.4	41.3	43.2	21	2943	2.9
Manufacturing	33.1	23.4	38.9	41	20155	20.2
Electricity, etc.	9.3	10.1	9.7	10.9	1111	1.1
Construction	37.5	35	63	56.6	8420	8.4
Wholesale	17.3	19.5	23.3	22.1	13752	13.8
Retail	28.1	22.7	36	40.7	12229	12.2
Accommodation	4.2	16.8	16.3	8.7	5631	5.6
Transport	19.1	34.2	42.4	28.8	5301	5.3
Communication	-94.4	-115.2	70.6	186.4	328	0.3
Finance	15.5	9.3	7.1	20	1711	1.7
Property	18.2	11.7	23.6	31.8	13855	13.9
Community services	20.9	25.3	22.4	25.3	8682	8.7
Cultural services	36.8	22.2	25.9	26.8	2148	2.2
Personal services	6.7	6.5	8.7	10.9	2137	2.1
Total					99835	100.0

Source: ABS Catalogue 8140.0 1993-94

BUSINESS OPERATIONS AND INDUSTRY PERFORMANCE AUSTRALIA AVERAGES OF YEARS 1990/91-1993/94



Appendix 5

Cost of Listing - Industrials: March 1996

Amount sought	No. of Floats	Average Cost $m.	Average % of Amount Sought
<$10m	6	0.4	12
$10m-$20m	1	1.0	7
>$20m	7	3.0	4

Source: Price Waterhouse - Survey of Sharemarket Floats

Appendix 6

Source: Reserve Bank Bulletin