EMERGING TRENDS IN BUSINESS FINANCE: AFIA PERSPECTIVE

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[July 2018]

INTRODUCTION

Australia has a broad and deep range of finance providers and products that continue to emerge to facilitate business customers create or take up opportunities to stimulate economic growth and regional development. The focus of this paper is on debt finance available to small to medium-sized business customers [SMEs] offered by members of the Australian Finance Industry Association [AFIA]. AFIA SME finance members range from ASX-listed bank and non-bank financiers, OEM-captives, independents through to entities that are SMEs in their own right. Distribution channels include direct or via intermediaries and online access. Products offered are designed to suit SMEs through their life-cycle from start-up, day-to-day consolidation and growth through to major expansion as the business matures.

Key types include: equipment or asset finance and a range of working capital solutions designed to minimise the need for SMEs to spend their personal income or put at risk personal assets including the family-home. Enabling access to affordable capital facilitates innovation and risk-taking with flow-ons to improved capital market efficiency. Diversity in product and providers enables access to SME finance by the financially underserved or disenfranchised segments of the SME population.

AFIA recognises that to have sustainable, long-term growth, our members need to cultivate trust and provide finance in a way that meets community standards and expectations; a key theme emerging from the Banking & Financial Services Royal Commission. Equally, Government intervention and regulation of SME finance needs to be appropriate and proportionate to balance SME protection while encouraging diverse and innovative finance offerings. In AFIA's view, a key limitation in utilisation of non-traditional bank finance by SMEs to support and grow their businesses is a lack of awareness or understanding by SMEs and their trusted-advisers of the diversity and depth of alternate options for SME finance currently available in Australia.

AFIA BACKGROUND

AFIA is well place placed to comment on emerging trends in SME finance given our broad and diverse membership operating in the commercial market. By way of overview, AFIA launched under its new brand in 2017 culminating a strategic review that brought together the entities formally known as the Australian Finance Conference [AFC], the Australian Equipment Lessors Association [AELA], the Debtor & Invoice Finance Association [DIFA] and the Australian Fleet Lessors Association [AFLA]. Collectively these Associations have advocated on behalf of our industry for six decades.

Our new structure ensures continuation of a strong and mature representative voice under key product groupings which include for commercial finance the:

- Equipment Finance Division - with equipment and asset finance (including leasing) facilitating a large component of the nation's equipment capital expenditure, members of this Division are vitally involved in the equipping of Australia's productive base;
- Fleet Leasing & Rental Division – members provide fleet leasing, rental and management services for close to 700,000 vehicles Australia-wide[1];

[1] AFIA Fleet Leasing & Rental Division Statistical Report (April 2018)

- Motor Finance Division - provide services and support to businesses that offer finance to consumers and commercial customers to acquire or utilise motor vehicle assets; and
- Working Capital Division - represents members that offer working capital finance to commercial entities via: debtor & invoice finance; trade finance; insurance premium finance; online SME loans and commercial credit cards & other revolving products.

Financier members range from ASX-listed bank and non-bank financiers and include captive / OEM financiers, independents and structurers/packagers. They operate through the various distribution channels including broker / intermediaries, Point-of-Sale/Suppliers or Retailers and online/digital means. In providing their finance products AFIA members continually review and adapt operations harnessing technological developments (eg utilisation of big data to support automated credit-decisioning) or enhancements (eg digital contracting) to remove friction and meet or enhance customer experience and take-up.

AFIA also provides for membership of suppliers of goods or services to our industry (eg professional service legal, compliance or accounting providers, IT/Regtech providers) through the category of Associate Member.

Collectively AFIA has worked with governments, key policy decision-makers and regulators over the last 60 years. Areas of focus for the commercial market has included: international lease accounting standards, personal property securities reform, taxation (at both the state and federal levels), anti-money laundering / counter-terrorist finance regulation and proposed expansion of consumer-regulation to the SME sector.

Our transformation sees AFIA well-placed to advocate on behalf of a sector that contributes $152B to Australia's GDP amd employs approximately 450,000. AFIA supports the businesses and brands that enable Australians to realise their dreams by financing Australia's future through sustainable lending practices. More detail on AFIA is available from: www.afia.asn.au.

TYPES OF DEBT-TYPE FINANCING + PARTICIPANTS

Selection of the appropriate debt finance options is driven by the particular circumstances of the SME (including its age, size, industry of operation). Key metrics that influence product choice include: expected time finance is required, flexibility required, overall cost, security / collateral required to support the finance.

Debt finance products are generally grouped into two categories:
- Equipment / Asset Finance; and
- Working Capital Finance.

Commercial finance may also entail commercial property finance (for development / construction), but as this is not a dominant component offered by our non-bank SME financiers, it is not covered in this paper.

PART A: EQUIPMENT / ASSET FINANCE

Equipment or asset finance enables SMEs to use external financing provided by AFIA members to acquire necessary business assets to complete business operations while allowing the SME to retain their company's capital or for smaller / start-up businesses with low available capital to avoid making personal investments on these items. A wide spread of funding options provides a spectrum of choice, enabling SMEs to select the level of risk and service they require. At one end of the spectrum, the SME can assume the asset risk and operating costs associated with the equipment, while at the other the risks and administration can be assumed by the equipment financier. In between, the SME can select the combination of risk, service and ownership structure that suits their particular needs. A full financing solution can provide an SME with

installation, maintenance, training and ancillary items included for a single periodic payment over the term of the equipment finance transaction.

There are three main types of equipment or asset finance available in Australia: equipment lease (finance or operating), hire-purchase and chattel mortgage. Key features of these products follow:

1) EQUIPMENT LEASE

A lease is an agreement between a financier / lessor (owner of the equipment / asset) to provide the SME customer/ lessee the right to use the equipment / asset in return for a structured series of payments over a period of time (generally tied to the useful or effective life of the equipment / asset). Lease finance in Australia is a mature financial product having been offered as part of a portfolio of financing techniques for over some six decades. In terms of general market functioning, leases are written for most capital equipment items (provided they are used for commercial purposes) and for periods ranging between two and five years; implicit rates are competitive and are usually fixed for the period of the lease. Providing the commercial use test is met, lessees claim the full amount of the lease rentals as a tax deduction; the lessor, as owner, usually claims the depreciation and usually any investment incentives – the latter in the case of the Investment Allowance (when applicable) can be claimed by either the lessee or the lessor as appropriate, with leasing's tax benefit transfer capacity reflecting the incentive of the Allowance in the amount of the lease rentals. More specifically:

<u>Finance Lease</u>

- No deposit to approved SMEs conserving capital.
- Match the lease to the length of time the equipment is required by the SME - lease terms available generally 12 – 60 months;
- SME rents the goods; has no ownership entitlement and accepts the residual value risk (ie risk value of asset at end of lease term being less than had been agreed at the outset taking into account ATO guidelines – SME responsible for shortfall);
- In any event the finance lease will provide for the lessee to indemnify the lessor for any loss on sale for less than the residual value; this provision aims at ensuring that the lessee properly maintains and uses the equipment and, from a pricing point of view, keeps any equipment technological risk implicit in the credit risk.
- Rental payments / cash flow patterns are able to be structured to suit working capital needs;
- Rental payments may be fully tax deductible if the equipment is used solely for earning assessable income; and
- Lessor / financier claims input tax credit for GST, therefore lease priced to take this into account (ie amount based on GST-exclusive price of the asset/equipment). Lessor / financier also able to claim asset depreciation with this tax benefit transfer also able to be reflected in lease pricing. A business just starting out or one in the process of restructuring is unlikely to be generating current year taxable income. In these circumstances tax deductions for depreciation or investment incentives do not achieve their desired policy effect – rather they simply add to carry-forward losses. Through leasing, the lessor can claim these deductions against its taxable income, crystallise the benefit and pass it on to the lessee in the form of the tangible incentive of reduced cash repayments.

At the end of the lease the SME has the following options:

- Returning the equipment to the financier who can sell it in the market place. SME would need to make up the shortfall if the net sale was less than the agreed residual value; or
- Making an offer to the financier to purchase the equipment, which it may accept.

<u>Operating Lease</u>

- Use the equipment for an agreed time in return for rental repayments. Term generally 12 – 48 months (ie generally shorter than the useful life of the equipment / asset);
- Rental payments / cash flow patterns are able to be structured to suit working capital needs;
- No deposit to approved customers conserving capital;

- Lessor / financier bears residual value risk as goods generally returned at end of lease term with no further financial obligation on lessee (other than around end-of-lease condition guidelines);
- Rental payments may be fully tax deductible if the equipment is used solely for earning assessable income; and
- Lessor / financier claims input tax credit for GST, therefore lease priced to take this into account (ie amount based on GST-exclusive price of the asset/equipment). Lessor / financier also able to claim asset depreciation with this tax benefit transfer also able to be reflected in lease pricing.

At the end of the lease term the SME has the following options

- Return the equipment to the financier (eg to mitigate the risk of obsolescence and enhancing ability to upgrade under a new arrangement);
- Continue to rent the equipment; or
- Make an offer to the financier to purchase the equipment, which it may accept.

Equipment acquisitions better priced through financing via the finance method (i.e. longer depreciating items of plant), are now in many instances financed via commercial hire-purchase or chattel mortgage. Product selection was also heavily influenced by taxation policy. For example, the introduction of GST in July 2000 saw SMEs move from finance leases initially to hire-purchase (as the transitional GST arrangements did not apply to that product); then from leasing and hire-purchase to chattel mortgage (in large part because of an inequitable GST outcome for cash-based vs accrual-based SME taxpayers, though this has since been addressed following lobbying by AFIA [formerly AELA]). Chattel-mortgage remains the dominant equipment finance product.

2) HIRE PURCHASE

- While this product gives the SME the benefit of preserving its working capital as it pays off the asset or equipment, the SME is still considered the owner for tax and accounting purposes;
- As the owner of the equipment, the SME may be able to claim depreciation and interest costs as tax-deductible expenses;
- Deposits or trade-ins can be used to reduce the amount of finance obtained by the SME;
- Finance can be fully amortised across repayments or structured to have a final balloon payment at payable at the end to reduce the periodic payments and (implicit) interest rate generally fixed for the contract term;
- SME can tailor the payments to match its income cycles or seasonal requirements;
- Ownership of the equipment will pass once final payment is made. Term is generally 12-60 months;
- Repayments and residual balloon does not include a GST component; SME may be able to claim GST as an input tax credit. How SME claims depends on whether they account on a cash or accruals basis.

3) CHATTEL MORTGAGE

- SME holds ownership of the equipment, it may be able to claim depreciation and interest costs as tax-deductible expenses;
- Financier uses equipment as collateral or security for the loan;
- Deposits or trade-ins can be used to reduce the loan amount;
- Fixed interest rate for the term of the loan. Term generally 12-60 months;
- Payment structures to suit the SME individual requirements;
- SME can propose a balloon or final payment entirely tailored to it.
- Repayments and residual balloon does not include a GST component; the SME may be able to claim GST as an input tax credit. Can claim full GST when lodging next BAS regardless of basis on which SME accounts.

EQUIPMENT / ASSET FINANCE PROVIDERS:

The predominant lessor groups are finance companies and banks; lessees include all private and public industry sectors with around 20% of the economy's capital equipment being leased. Leasing and other equipment finance offered by members together account for around 40% of equipment capital expenditure.

Lease finance utilisation rose strongly as the acceptance of the philosophy of leasing broke down earlier attitudes against this non-equity form of financing. The current level of utilisation reflects this wide acceptance. Generally speaking leasing is offered as part of a range of financing products. This allows its particular merits vis-a-vis other finance methods to be weighed and tailored to the customer's particular needs and financial position. Applicants can usually choose between a number of sources including financiers/lessors with whom they have an existing relationship, those which may be offering leasing at the point of sale and those independently operating in the market.

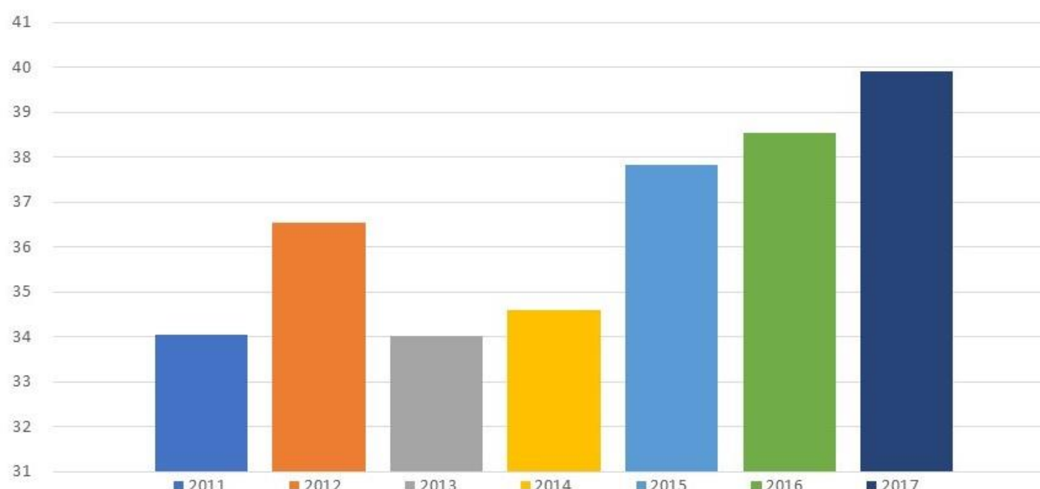
In Australia the main providers of lease finance were traditionally finance companies (including bank-owned lenders, general financiers and captives) and banks. Over the last decade or so nearly all the bank-owned finance companies have been brought into the parent. In recent years, the banks have been the predominant source of lease and other equipment finance, although improved access to funding has seen captives and independents improve their share. More recently with the emergence of the FinTech sector, the online offering of equipment or asset finance has increased with members of AFIA's Online SME Lending Group[2] offering product in this market segment.

Among these are specialised finance companies that offer more complex equipment finance (eg hybrid or structured leasing) that have additional tax advantages.

Lease packagers are involved in structuring some of the more complex transactions. Lease brokers also play a role in promoting the product.

MARKET OUTLOOK – AUSTRALIA

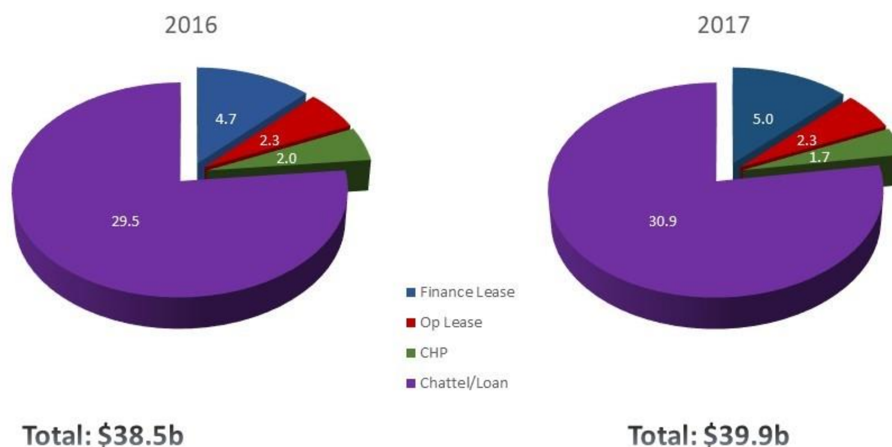
AFIA estimates that total new commercial equipment finance in 2017 was $39.9B, up strongly from 2016. Figures below taken from the AFIA Equipment Finance Division Annual Statistical Report (CY17 December 2017):



[2] For example, GetCapital: https://www.getcapital.com.au/business-finance-solutions/equipment-vehicle-finance/

Of this $8B was finance leases, $5.1B was operating leases (including fleets), $2B was hire purchase and $31.2B chattel mortgage.

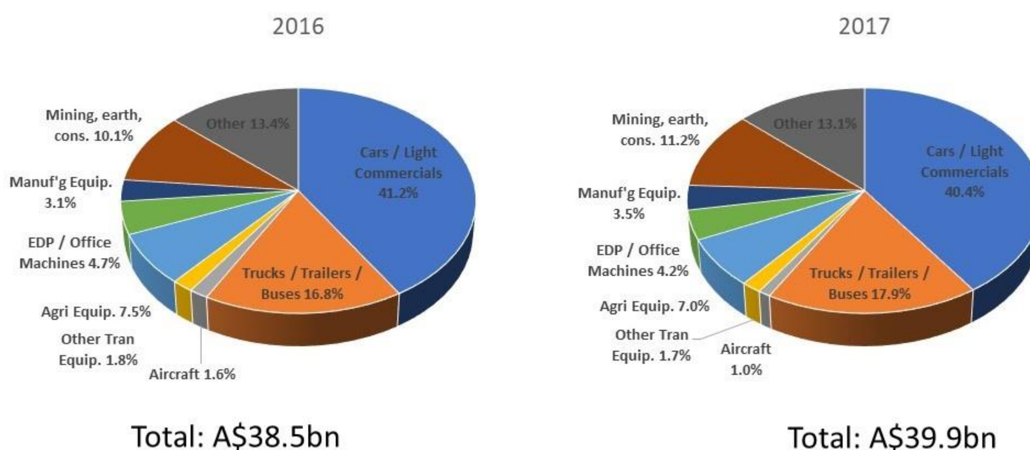
New Lending Volume by Product (A$bn)



Totals may not add due to rounding

Excluding the fleet leasing sector, 40% was for motor cars and light commercials, 18% for trucks, trailers and buses, 3% for aircraft and other transport equipment, 7% for agricultural machinery, 4% for EDP and office machines, 4% for manufacturing equipment, 11% for mining and construction and 13% for other items.

New Lending by Equipment Type



Totals may not add due to rounding

Net receivables has been growing over the last three years, surpassing the $100B mark and reaching $105B at the end of 2017.

A key area that may impact the take up of the operating lease product by SMEs going forwards is the introduction of a new lease accounting standard in Australia [AASB16] (and globally) to take effect from 1 January 2019. Under AASB16 there will no longer be a distinction between finance and operating leases for accounting purposes. Lessees will need to bring to account a right-to-use asset and lease liability onto their

balance sheet for all leases. Currently operating lease commitments do not need to be capitalised on the balance sheet and need only be disclosed by way of footnote to the published accounts. Bringing them onto the lessee balance sheet may impact any covenants (eg debt/equity ratios). Thought we note the impact of regulator focus on the November 2016 unfair contract terms provisions for standard form small business contracts and moves by the major banks not to rely on non-monetary default provisions going forwards. This is discussed further later in the paper.

MARKET OUTLOOK – INTERNATIONAL

Leasing remains the dominant equipment finance product taken up by commercial customers in the USA. US Equipment Finance & Leasing Association [ELFA] Monthly Leasing and Finance Index (MLFI-25), which reports economic activity from 25 companies representing a cross section of the US $1TR equipment finance sector, '*showed their overall new business volume for May was $7.7B, unchanged year-over-year from new business volume in May 2017. Volume was down 3 percent month-to-month from $7.9B in April. Year to date, cumulative new business volume was up 7 percent compared to 2017*'. As reported in the US ELFF Q2 2018 Equipment Leasing & Finance U.S. Economic Outlook, '*after solid growth in 2017 in the US market, equipment and software investment will likely continue to strengthen in 2018. Business investment is expected to expand robustly, and stable credit conditions should foster an environment conducive to growth. Overall, we expect the economy to grow 2.7% in 2018 (unchanged from our annual outlook), while equipment and software investment is projected to expand 8.5% (down from 9.1% in our annual outlook)*'.

Statistics provided in the Annual Report for the Canadian Leasing & Finance Association (FY 2016-17) noted: '*The asset-based nance market in Canada continued to grow in 2016-17 with new business volumes up 2.6% to $121.7 B which was slower than the 4.9% growth in 2015-16. New business activity was led by the automotive sector as the fleet vehicle market grew 8.0% and the consumer vehicle market 7.3% in 2016-17 while machinery and equipment (excluding commercial vehicles) slumped 16.4%. As a result, total assets financed rose 5.7% in 2016 to $379.2B down from the 6.8% growth of the year before. The Alta Group estimates that asset-based financing of equipment and commercial vehicles accounted for about 17% of all lending to business in Canada in 2015-16*'.

In the UK in 2017, members of the UK Finance & Leasing Association [FLA] '*provided a record £32 billion of finance to the business sector and public services, representing over a third of UK investment in machinery, equipment and purchased software in the UK last year. Of that total, £18.6B was provided to SMEs – 12% higher than in 2016 – demonstrating that leasing and hire purchase are vital sources of funding for SMEs.*'[3]

PART B: WORKING CAPITAL

Australia's SMEs are united in agreeing that cash flow problems are a major inhibitor of growth - but they have adopted a disparate range of responses to how they deal with managing their working capital to manage cash flow or fund growth opportunities. Two problems conspire to constrain the growth of today's SMEs: late paying customers stretch the liquidity of a SME to its limits and impose additional interest charges[4], while the more traditional bank-commercial overdraft (generally secured by the family home as collateral) provide an inflexible form of finance which is unable to respond to sudden increase in orders or market opportunities and rapid growth.

There are a range of products and providers currently available in the Australian market to offer SME alternates to meet their working capital demands. As awareness of the alternatives for small business financing increase we expect small business owners will increasingly explore alternative forms of finance.

[3] Details available from: https://fla.org.uk/index.php/asset-finance-2/

[4] The 2017 Payment Times and Practices Inquiry, conducted by the Australian Small Business and Family Enterprise Ombudsman [ASBFEO], found that in the last financial year one in four businesses experienced an average payment delay of 31 to 60 days past agreed terms.

Both the Productivity Commission[5] and the Australian Small Business & Family Enterprise Ombudsman[6] [ASBFEO] are advocating for SMEs to have better access to more affordable business funding, including working capital.

1) DEBTOR / RECEIVABLES FINANCE

Debtor or receivables finance is a form of financing in which a SME on a continuing basis assigns its receivables (effectively as security) to a Debtor Finance Provider which in turn provides a cash advance to the SME (may be up to 70-80% of the value of invoices outstanding at that time) to help bridge the cash flow gap between:

- Incurring expenses in providing goods or services to its customers; and
- Receiving payment (from its customers) of invoices for those goods or services.

The remainder is advanced to the SME on collection by the Debtor Finance provider. A fee is charged for both providing the finance and collections management. Any accounts not collected would also be taken into account from the final amount returned to the SME. Some Debtor Finance Providers may offer the product for a specific, sizeable invoice with a longer term to settle.

In many cases, the receivable for goods and services provided only becomes due sometime after expenses are incurred by the SME. While advances from the Debtor Finance Provider predominantly fund a Client's working capital, they can be used for other purposes.

Debtor or receivables finance is generally categorised by two types:

- Invoice Discounting ("Discounting"); and
- Debtor Factoring ("Factoring").

The major difference between the Discounting and Factoring products is that:

- Discounting is typically not disclosed to the debtor (i.e. the customer who is obliged to pay the invoice to the SME). As the SME generally continues to manage collection, it may be seen as a riskier product and priced accordingly; and
- Factoring is typically disclosed to the debtor so that they are aware the Debtor Finance Provider has been assigned the receivable and there is a higher degree of contact between the Debtor Finance Provider and the SME's debtors.

Factoring and Invoice Discounting provide a set of financial and professional services to defeat the problems of late payment and less-agile traditional overdraft facilities and enable businesses to survive the inevitable cash flow crises and realise their growth potential.

Factoring and Invoice Discounting provide a solution which reflects the current performance of a business, and not the past performance. For companies growing rapidly audited accounts reflect history, whereas current sales show current performance. Factoring and Discounting products are inextricably linked with current sales and provide a finance solution which does not only accommodate but fosters strong growth performance.

Lack of commercial bargaining power may inhibit the ability of SMEs to generate additional cash from internal sources. Suppliers may be larger, and unlikely to offer extended payment terms. Customers may be in a position to resist or may be unable to make earlier payments. Factoring and Invoice Discounting can assist a business in overcoming its lack of bargaining power.

The advantages to be gained by users of Factoring and Invoice Discounting include:

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[5] https://www.pc.gov.au/inquiries/completed/capital and more recently: http://www.pc.gov.au/news-media/pc-news/financial-system

[6] http://asbfeo.gov.au/inquiries/affordable-capital-sme-growth

- freeing of cash within 48 hours, usually varying between 75 per cent – 90 per cent, of the value of an invoice as soon as it is issued; this allows business to accelerate growth;
- the ability to utilise the cash flow to obtain early settlement discounts from suppliers/creditors of up to 5 per cent;
- the reduction of management time spent on chasing slow payers enables managers to concentrate on areas more appropriate to their responsibilities, such as finding new business;
- the availability of bad debt insurance (known as non-recourse factoring)

By making maximum use of one of a company's most significant assets – its unpaid invoices – AFIA members in our Working Capital Division (Debtor & Invoice Finance) can give a SME the development opportunity it needs to be able to grow and compete rather than merely survive.

DEBTOR / RECEIVABLES FINANCE PROVIDERS:

AFIA Debtor Finance Providers include both bank[7] and non-bank entities[8] (with online provision emerging in line with other product offerings by AFIA members[9]). Key attributes that may differentiate the non-bank provider include: the level of service – frequent SME/debtor interaction vs. low ratio of SME to operational staff reflected in a high net promoter score; a more complete product suite offering both products (banks have preference for discounting facilities typically extended to larger SMEs); and not being an ADI is not subject to bank regulatory capital requirements or regulation by the Australian Prudential Regulatory Authority (APRA)[10]. However, non-ADI Debtor Finance Providers remained challenged by access and cost of wholesale and other funding to support their business models which in turn impacts their product pricing.

MARKET OUTLOOK – AUSTRALIA

The Debtor Finance market in Australia has grown significantly over the last two decades with Industry Turnover increasing from $3.9B in 1996 to in excess of $62.5B in 2016[11].

A significant proportion of AFIA Debt Finance Provider customers are typically SMEs that operate in the following key industries:

- Manufacturing - where 'manufacturing relates to the physical or chemical transformation of material or components into new products'
- Agriculture & Mining - includes all clients engaged in providing related services such as sheep shearing, aerial agricultural services, harvesting or forest protection, mineral exploration on own account, in provision of services to mining or mineral exploration, and mining enterprises under development.
- Construction - includes all clients engaged in special trade construction such as plumbing, earthmoving and dredging, painting etc.
- Wholesale Trade - includes all clients engaged in the resale of goods to retailers or other wholesalers, or to institutional (including Government), professional or other business users.
- Retail Trade - includes all clients engaged in the resale of goods to final consumers for personal or household consumption.
- Transport & storage - includes all clients engaged in providing terminal and storage facilities; services related to transport, booking, travel, forwarding, material handling etc.
- Property & Business Services - includes all clients engaged in valuing, purchasing, selling, renting, leasing or managing real estate; developing or subdividing land; scientific research and meteorological services; providing technical, legal, accounting and other business services; and renting and hiring equipment (except cars, trucks and other transport equipment).

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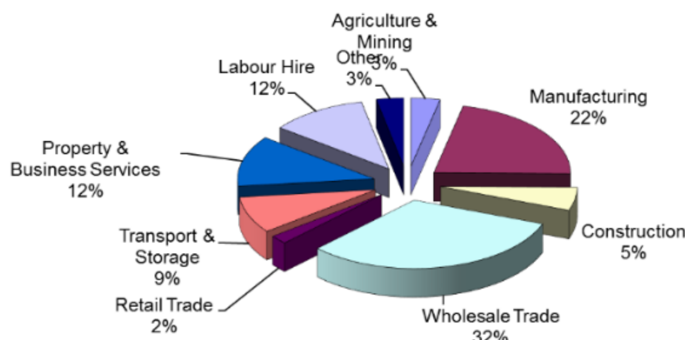
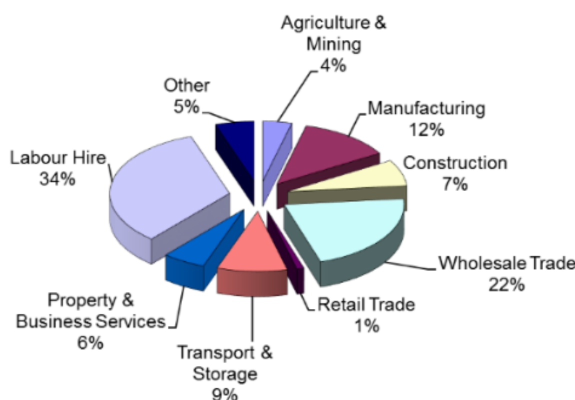
[7] Westpac, Bendigo & Adelaide Bank, Bank of China, NAB
[8] Scottish Pacific Business Finance, MoneyTech, Classic Funding Group, Invoice Money, APositive
[9] For example, by Prospa https://www.prospa.com/invoice-now/
[10] Scottish Pacific Group Prospectus (2016)
[11] AFIA Working Capital Division (Debtor & Invoice Finance Group) Report (2016)

- Other -all clients engaged in enterprises not elsewhere classified

March Quarter 2017
Percentage of Discounting Turnover



March Quarter 2017
Percentage of Factoring Turnover



[12]

Based on members feedback, our Debtor Finance Providers appear to demonstrated resilient performance through the challenging business and economic cycle of the last decade with consistently low stand-alone loss ratios.

For growth SMEs using alternative lending options, based on published data[13], we understand that debtor finance is by far the most popular working capital choice. The alternative working capital options used by SME respondents in 2017 were: debtor finance (used by 77%), merchant cash advances (23%), P2P lending (10%), crowd funding (9%) and other online lending (5%). Given the prolific media profiling of the growing fintech market, these results may seem surprising. However, the Index polls SMEs with a turnover ranging from $1 million to $20 million and it is likely that most of the current fintech take-up is from start-ups and small businesses coming in under the $1 million revenue mark.

MARKET OUTLOOK – INTERNATIONAL

In the US market, members of the US Commercial Finance Association reported[14]: Domestic factoring volume increased 6.9% from 2016 to 2017. International factoring volume remained steady at US $6.7B over the

[12] AFIA Working Capital Division (Debtor & Invoice Finance Group) Report (March Q 2017)
[13] Scottish Pacific Group SME Growth Index March 2018
[14] http://higherlogicdownload.s3.amazonaws.com/CFA/5af7a9c9-58cf-45d6-9b3cbcb8cecd80cc/UploadedImages/Annual_ABL_Report_2018.pdf

same period. Market share for notification factoring decreased 690 basis points in 2017 to 70.7% of total reported factoring volume.

In the UK, quarterly sales volumes in debt / receivables finance for the UK market reflect that in 2017 Q2 domestic invoice discounting reached £62.7B and domestic factoring reached *£4.809B*[15].

2) ONLINE SMALL BUSINESS LOANS

To address an area in SME lending underserved by the traditional banks, members of the AFIA Working Capital Division (Online Small Business Loans Group)[16] offer fast, flexible loan solutions, with decisions and funding generally often by the next business day. Key features of the product are:

- simple, online business loan;
- generally no asset security required to access funds – cash flow performance dominant criteria to assess serviceability and capacity;
- principal amount – varies between providers – median less than $100 000 and terms median less than 12 months with individualised, risk-based pricing;
- Funding generally sourced from the wholesale market or other non-deposit-taking sources consequently funding costs higher than traditional banks with SME loan product pricing reflecting this higher cost; and
- automated direct debit instalments on a daily, weekly or fortnightly basis.

To deliver these quick funding outcomes, members utilise proprietary automated credit-decisioning tools to assesses hundreds of data points from customers' financial information, government data and credit bureau data. To this they overlay management requirements such as credit quality, distribution and profit margin. As portfolios grow and for those with overseas parents, further refinement to algorithms from large historic base of SME data drive improved credit decisions and predictability of loan-book performance. In turn this assists access to better-priced wholesale and other funding with savings able to be factored into product pricing for SME customers.

ONLINE SME LOAN PROVIDERS:

Online SME Loan Providers consist of a mixture of on-balance sheet members and market place or peer-to-peer lenders. A key differentiator relates to where funding is sourced and consequently who is the entity that bears the risk; for on-balance sheet lenders the risk lies with their business. Currently, AFIA Online SME Lenders largely operate as on-balance sheet lenders; though we recognise marketplace lenders play an important role in providing loan finance alternates to SMEs.

The key business model for providers in this market segment is the use of technology as a focal point of their business model to specifically address the financing needs of SMEs. This facilitates a fast, efficient application and credit-decisioning process to provide same day decisions for most loans, compared to weeks (or even months) for more traditional lenders with a bricks and mortar presence. Our members also have established, multi-channel distribution networks (with a focus on strong direct marketing and relationships with partners including small business accounting software providers, finance brokers and other POS intermediaries).

MARKET OUTLOOK – AUSTRALIA

We are not aware of any current authoritative published source on the size of the online SME lending market size in Australia. AFIA is looking to address this omission through the creation of a statistical report similar to what is produced for our other membership commercial finance segments. Based on information currently available, recent growth figures indicate that while the online lending sector is relatively new it is a viable

[15] Data obtained from: https://www.statista.com/statistics/470773/factoring-sales-volumes-by-type-in-united-kingdom/
[16] Currently consists of six entities: Capify, GetCapital, Moula, OnDeck, Prospa and Spotcap

disruptor to incumbent small business lenders; for both consumer and business lending growing by 53% in the 12 months to 31 December 2016 to $819 million[17].

As was reflected in the Prospa prospectus[18], a rough assessment using a combination of publicly available market data in relation to the number of small businesses in Australia and internally generated data and certain assumptions around their need for finance suggested that:

> '*of the 2.2 million small businesses in Australia[19], only 1.6 million make an annual turnover of over $50,000, representing businesses considered to be of a sufficient size to be funded by business loans. Of these small businesses, 1.1 million would have a risk profile and customer need consistent with risk criteria and product offering based on the above assumptions. At our average loan size of $26,000, our estimate of market opportunity for small business lending in Australia is therefore in excess of $20B.*'

Prospa has served over 12,000 unique customers since its establishment in 2012, which accounts for approximately 1% of the 1.1 million small businesses in Australia estimated to have risk profiles acceptable to their business model (based on certain assumptions). Based on feedback from Prospa and our other members in this market segment, the use of online SME lenders by Australian SMEs is increasing due to their ability to provide easy online application processes, timely credit decisions and funding, unsecured finance and payment flexibility. Feedback from all members is also a high levels of customer satisfaction (reflected in high Net Promoter Scores) and, more importantly, customer repeatability, with generally greater than 50% of existing customers looking to obtain another facility at loan completion.

Our Online SME Loan Providers have a diverse distribution of customers across industry, geography, time in trading and size. Most will generally require the SME to have been in business for at least 12 months. Key industry segments include: retail; building & trade; manufacturing; hospitality; professional services; transport; finance and wholesaling.

AFIA's Online SME Lenders Group has also proactively worked to build trust in its product and providers that offer it through development of a Lending Code of Practice with a focus on greater transparency (including for pricing) and accountability. The Code culminates work engaged in by the ASBFEO in collaboration with FinTechAustralia and the SME advocate (theBankDoctor.org) with AFIA delivering the commitment to develop a Code by 30 June 2018.

MARKET OUTLOOK – INTERNATIONAL

As was reported in 'Cultivating Growth: the 2nd Asia Pacific Region Alternative Finance Industry Report (September 2017): '*in 2016, more than US$245bn of funding was channelled through online alternative finance platforms across the Asia-Pacific region, providing credit for consumers, capital for start-ups and SMEs, donations for NGOs and third-sector organisations. Although Mainland China still dominated the market with over US$243bn raised in 2016, many other countries such as Australia, South Korea, Malaysia and Thailand also saw considerable growth in the year. The online alternative finance industry is definitely taking roots and thriving in the world's most populous region*'.[20]

The online SME loan market segment in the USA is mature and deep servicing 30.2M small businesses. In 2016, 5.7 million loans under US$100,000 (valued at US $82.6B) were issued by USA lending institutions to the reporting under the Community Reinvestment Act[21]. While we have not been able to find authoritative

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[17] Total Market Volume in Australia. KPMG/UniofCambridge/MonashUni "Cultivating Growth" 2nd Asia Pacific Region Alternative Finance Industry Report (September 2017). USDAUD FX rate of 1.344 (weighted average for CY16).
[18] Prospa Group Limited Prospectus June 2018
[19] Small businesses defined as having fewer than 20 employees, including non-employing businesses; ABS 8165 (Counts of Australian Businesses including Entries and Exists). June 2017 (released in February 2018).
[20] KPMG/UniofCambridge/MonashUni "Cultivating Growth" 2nd Asia Pacific Region Alternative Finance Industry Report (September 2017).
[21] US SBA Office of Advocacy United States Small Business Profile, 2018 (Source: FFIEC)

statistics to substantiate the share provided by online SME lenders as an aggregate, a major participant has reported approximately US$8B in total originations servicing 80,000 small businesses as at CY2017.

3) INSURANCE PREMIUM FUNDING

Insurance premium funding provided by AFIA members enables businesses to pay their commercial insurance premiums (including Workers Compensation; Professional Indemnity) in easy to manage monthly instalments rather than an upfront lump sum freeing up business cash flow for use elsewhere. Key benefits of Insurance Premium Funding for SMEs includes:

- Flexible monthly instalments at competitive interest rates
- Multiple payment methods, including direct debit and credit card
- Able to combine and pay multiple insurance policies with one easy monthly payment and structure to match the SME cash profile
- Interest repayments may be tax deductible
- Generally simple loan documentation – as no security or directors guarantees required
- Free up SME cash flow to use elsewhere in their business and increases affordability of insurance cover to better protect business operations
- Should not interfere with existing finance (eg bank overdrafts and loans).

INSURANCE PREMIUM FINANCE PROVIDERS:

AFIA Insurance Premium Finance Providers are a mixture of bank[22] and non-bank financiers[23]. Products are generally distributed via insurance brokers or online applications.

MARKET OUTLOOK – AUSTRALIA

Based on market provided by AFIA members and reflected in our Insurance Premium Funding Report, relevant market data for commercial products is summarised below:

MARKET OUTLOOK – INTERNATIONAL

AFIA does not have data on the size or trends in the global insurance premium funding market for SMEs.

[22] BOQ Finance, Westpac, Macquarie Premium Funding
[23] Attvest, BMW Finance Australia, Elantis Finance, Hunter Premium Funding (Allianz), Westlawn(NorthState), Principal Finance, QPR Premium Funding

4) MERCHANT CASH ADVANCE

A merchant cash advance is a product for SMES that predominantly accepts credit or debit cards as payment and is suited to retailers on and offline. Merchant cash advances appear similar to unsecured business loans however; they are the process by which a lender technically purchases future transactions and advances the SME a percentage of their sales. As future sales support repayment the SME owner's credit history may often not be a critical factor for approval. Evidence of a regular and predictable flow of credit or debit card transactions will help the SME find the funds they need to repay the Merchant Cash Advance when traditional small business financing is unavailable. The product can be more expensive than a traditional business term loan but are less expensive than other short-term financing options and may assist a SME take advantage of an unusual business opportunity or a short-term spike in trading.

Many SMEs face low cash flow issues in the business environment. SME owners can use short-term merchant cash advances (potentially up to $250,000) as a way of improving their working capital with access quantum based on a monthly average turnover and length of operation in business. These allow SMEs to continue business operations in the absence of actual cash flow. Merchant Cash Advance payments have no fixed term. Funds can be used to: pay off expenses, buy more stock, hire staff or upgrade equipment. Under traditional facilities, SME owners can then repay the advances as they collect cash from customer accounts or make additional sales. A recent market entrant (and AFIA member[24]) offers an alternate payment mechanism with repayment based on an agreed % of future EFTPOS sales. This means when business is slow, the SME is able to pay less. When its booming it pays more. The advance is offered on an unsecured basis and priced based around a 'factor fee' which is agreed upon at approval. Application and credit-decisions can be completed efficiently and with SMEs advised within 24-48 hours of the outcome. Once approved, funds are deposited into the SME account. SMEs may find the quick access to funds and the potentially higher cost are outweighed by convenience.

MERCHANT CASH ADVANCE PROVIDERS

The dominant participants in AFIA membership offering the merchant capital product are non-bank financiers that operate in a largely online environment.

MARKET OUTLOOK – AUSTRALIA

Based on market feedback, we understand that a typical SME with declining or stable revenue is more likely to use merchant cash advances to provide working capital and more likely to offer discounts for early payment. Providers look to utilise access to data (eg linking bank transactional data) to facilitate and increase efficiencies through automated-credit decisioning. This enables faster processing times and better analysis of risk to facilitate a broader scope of approved-SME borrowers.

MARKET OUTLOOK – INTERNATIONAL

AFIA does not have data on the size or trends in the global merchant capital finance market for SMEs. However, anecdotally our members have indicated the product has depth and maturity in a range of countries including the USA, South Africa and the UK.

5) CORPORATE CREDIT CARDS + REVOLVING CREDIT

Corporate credit cards issued by AFIA members[25] provide a means for SME to benefit from being able to acquire assets or services to grow their business providing a term (eg up to 51 days) before payment is required assisting with cash flow management. By making the SME supplier payments line up with their

[24] Beyond Merchant Capital
[25] Non-bank: American Express Australia; Latitude Financial Services; Bank members: major banks

preferred statement cycle, the SME could have business receivables coming in before business expenses are going out. Transaction reporting may also assist the SME to track expenses and better monitor cash flow. Reconciliation of costs through downloading of online statements directly to accounting/book-keeping software also eases business cost management. Products may also be designed to facilitate no pre-set spending limits which allows the limit to adjust based on spending patterns, payment history and credit records. This facilitates the SME using the card to make large purchases (eg utilities, insurance). while also covering everyday expenses like travel, fuel and utilities.

A recent development has seen one of our members[26] partner with a Credit Card Scheme to expand virtual card adoption on their online booking tool. The solution is a widely used technology in other countries. By generating a unique virtual card number (VCN) for each online travel reservation, it provides greater security and payment traceability. The VCN gives the SME more flexibility with payment deadlines by providing access to a credit line at no cost. This flexibility allows the SME to pay its suppliers according to their terms and then for the SME to settle with its VCN provider at a later date. This extra time gives the SME a buffer to allow customer payments to come in or to invest working capital in other areas to grow its business.

MAJOR REGULATORY ISSUES + HOW IS TECHNOLOGY CHANGING THE NATURE OF BUSINESS FINANCE?

Recent years has seen increasing re-regulation of the financial services industry. This regulatory upswing has been driven by public perceptions of poor conduct by the industry in a populist political landscape where the incumbent Federal Government lacks a strong electoral mandate. This has led to an increasing focus on the culture of financial service providers as a driver of behaviour by Government, departmental policy makers and regulators. Some key areas are noted below:

1) ROYAL COMMISSION DIRECTION

As noted earlier, the standard by which SME providers are to be judged going forwards is whether they have behaved in a manner that meets the standard of community expectations which encompasses more than strict legal compliance. Public hearings focussing on small business lending were held 21 May-1 June. The key issues focused on in case studies included credit assessments processes (badged responsible lending) and the taking of guarantees. Self-regulation (via Banking Code of Practice) including how small business is defined was also area of focus.

Key takeouts have included:

Responsible Lending: no proposal to recommend additional statutory obligations should be imposed on small business lending (eg not proposing to recommend extension of NCCPA). However, Commission is to examine further: questions including whether any of the provisions of the NCCPA which apply to consumer credit contracts also apply to credit contracts with small and medium sized business commerce. If so, why and to which small and medium business customers? If not, why not? How much responsibility the borrower and lender bear in assessing the cash flow forecasts and other factors when deciding whether to enter into a small business loan contract? What are the outer limits (and should they be codified) of a bank's duty to act as a prudent and diligent banker in assessing a business loan application – noting it requires consideration of two separate issues:

(1) the nature of the obligation to the borrower; and
(2) the nature of the content of the duty?

Third Party Guarantors: Is the current range of protections (in statute and common law/general unconscionability principles) and avenues available to pursue those protections for guarantors sufficient? Is it desirable to take steps to increase the likelihood that a third party guarantor of business borrowings will be properly advised and make an informed decision before entering into a guarantee? And, if so, what

[26] WEX Australia. Further details: https://www.wexaustralia.com/virtual-payments/

might those steps be? What difficulties will be created for banks or borrowers by steps that require more information to be provided to legal or financial advisors of a guarantor before the guarantee is signed?

Conflicted Remuneration: the Commission focus has been on remuneration structures that incentivise the selling of products which may not be in the interests or of value to a consumer. However, AFIA is looking at implications for SME lending.

2) EXPANSION OF 'CONSUMER' CONCESSIONS TO SMEs

Expansion of concessions which treat small business like individual consumers have also been a feature given the political importance of the small business constituency. These have included statutory amendments to move to a single external dispute resolution scheme (the Australian Financial Complaints Authority[AFCA] and increased jurisdiction to consider complaints relating to a business employing up to 100 people and a credit facility up to $5M. AFIA members that operate in the consumer market are obliged to be a member of AFCA which also sees their SME portfolio open to complaint. Other AFIA members, most recently our Online SME Lenders Group are proactively facilitating SME customers having access to EDR by volunteering to become AFCA subscribers.

Further, November 2016 saw the unfair contract terms protections [UCT] originally implemented for consumers expanded to capture standard form small business contracts. Regulator focus (eg by ASIC[27] and ACCC) together with a focus of the ASBFEO on compliance with these provisions by the major banks has resulted in a range of terms agreed to be omitted from contracts. These include:

- Terms that give SME financiers a very broad discretion to unilaterally vary terms and conditions of the contract;
- Terms that provide for loan 'default' (such as non-monetary default) in a very broad range of circumstances, rather than where the borrower has materially defaulted on their obligations;
- Terms that absolve the SME financier from responsibility for conduct, statements or representations that the SME Financier makes to borrowers outside of the contract (otherwise known as 'entire agreement clauses'); and
- Terms that too broadly indemnify the SME Financier against losses, costs, liabilities and expenses.

AFIA members and other SME non-bank financiers are reviewing compliance against these requirements recognising that while there may be justification for retention based on a legitimate business case for inclusion, the current compliance standard of community expectation will likely see the need for omission.

Further the Government has also announced a change to the Competition & Consumer Act definition of 'consumer' which currently captures SME but would expand access increasing the monetary threshold to $100,000 and potentially applying the consumer guarantees to online auctions.

3) OPEN BANKING & MANDATORY CCR

Government policies around open banking and mandating comprehensive credit reporting are seen to provide the environment for greater access to more data to facilitate better credit decisioning and enhance innovation; an outcome supported by AFIA with the potential to facilitate enhanced access and risk-based pricing to SMEs. However, with mandatory CCR, AFIA notes statutory limitations with access to a key predictive data element, namely, repayment history information, being tied to the holding of an Australian Credit License, means its potential is devalued with SME financiers unable, at this time, to access that dataset.

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AFIA sees the potential for open banking through improved data access to lead to new products and services that transform SMEs experience in financial services. Increased data access should also assist our SME providers to reduce their regulatory compliance costs. We also acknowledge the need for the critical position of the data providers to be appropriately managed through this process and the need for design

[27] ASIC Report 565: Unfair Contract Terms + Small Business Loans

implementation to avoid significant harm to consumers or SMEs and not to adversely affect well-regulated financial institutions (including AFIA members).

4) PERSONAL PROPERTY SECURITY REFORM

The Personal Property Security laws [PPSA] assist our SME Financier Members involved in equipment, motor or debt/receivables finance to manage risk and price their products accordingly. AFIA members are key stakeholders in the PPS reforms and utilisers of the PPSR[28]. AFIA continues to propose significant changes to the PPSA to enhance value of registrations and searches against identifiable goods, in addition to registrations against grantors. Ongoing discussions with Government indicate the proposed changes have been well-received and are to be incorporated in foreshadowed amendments to the PPSA as a result of Bruce Whittaker's 2015 Statutory Review of the Act and its operation.

While the PPSA offers benefits to secured financiers, it also presents significant risks which can sometimes result in diminished or lost security rights. In some instances, these risks cannot be effectively managed by a secured party, due to circumstances beyond its control, even if it has correctly registered its security interest in a timely fashion. These risks arise particularly in relation to equipment sub-leasing and inter-corporate group equipment hiring arrangements. Members' attention has been drawn to these risks and their management through various guidance consequent on the introduction of the PPSA. Many of the risks arise from considerable uncertainty about the scope and complexity of important terminology used in the Act and the PPS Regulations, in particular the definitions of "motor vehicle", "serial-numbered goods/property" and "other goods". Also, presenting a risk challenge is the fact the PPSR is primarily a grantor-name based register, which diminishes the opportunity to ascertain if specific equipment is subject to security interest except in limited circumstances.

AFIA Members' concerns and requirements have been well-documented through the PPSA statutory review process and in ongoing discussions with, and representations to, the Attorney-General and the Attorney-General's Department, Australia Financial Security Authority, the PPS Registrar and AFIA Members.

To address Members' concerns, and drawing on the Whittaker Recommendations in the Statutory Review Report, the key elements of AFIA's proposed enhanced PPSA regime for identifiable goods would:

a) Replace the terminology "collateral that must or may be described by serial number" with "serial-numbered goods" being "goods bearing a serial number" (a combination of numbers and/or letters and/or (possibly) symbols that appear to uniquely identify it).
b) Change the collateral classes to the six recommended in the Whittaker Report, including a collateral class of "serial-numbered goods" with sub-classes of:
    a. Goods with a Vehicle Identification Number ('VIN')
    b. Goods with a Hull Identification Number ('HIN')
    c. Aircraft
    d. Other serial-numbered (or identifiable) goods, referred to as property with a Property Identification Number ('PIN').
c) Replace the concepts of "motor vehicles" and "watercraft" with the concepts of goods with a VIN and goods with a HIN, respectively. In other words, a good will only be a:
    a. motor vehicle if it can be identified by a VIN affixed to it; or
    b. watercraft if it can be identified by a HIN affixed to it.
d) Retain the collateral class "Other Goods" for goods not specifically identifiable for the purposes of a security interest, for example, goods subject to bailment or retention of title arrangements.
e) Exclude registered securities over goods with a VIN, a HIN or a PIN from the vesting rules (ss 267 – 267A), even if the grantor is not correctly identified, if at all.

[28] AFIA Members have year-on-year financed a significant % of new + used motor vehicle acquisitions. Motor vehicle is the most common type of collateral class of registrations on the PPSR. At 31 March 2018, there were 4,797,473 current registrations on the PPSR with a motor vehicle collateral class. This was 48.8% of total current registrations. AFSA March Quarter PPSR Statistics 2018

f) Confine the taking-free provision (s 44) applying if a serial number is incorrect or missing only to goods with a VIN or a HIN, but not to goods with a PIN.
g) Confine the taking-free provision (s 45) applying to motor vehicles only to purchases of goods with a VIN from motor dealers licensed in the State or Territory in which the dealer sold the property.
h) Confine the beneficiary of the taking-free rules (s 43 – 47) only to buyers, not lessees.
i) Provide that a registered security interest over serial-numbered goods which has PMSI super-priority also has priority over any other security interest over that specific goods, regardless of who has possession of the goods.
j) Simplify and clarify grantor identifiers, especially for searching.

AFIA has also proposed/supported other changes covering matters such as the grantor details not being required for registrations against trusts, allowing a registration to cover a number of collateral classes, removing the distinction between "consumer property" and "commercial property", making clear a person who has possession of goods only becomes a grantor when they commence to hold the goods in that capacity, abolishing the vesting rules in the Corporations Act, and PPSR refinements (e.g. remove proceeds, inventory and PMSI boxes). All these proposed/supported changes are Whittaker Recommendations which will provide greater clarity and ease of understanding and operation of the PPSA and the PPSR.

AFIA believes the enhanced identifiable goods regime together with the above Whittaker Recommendations will allow for better management and control of PPSA risks and enhance the commercial effectiveness of the overall PPSA regime for all stakeholders, especially AFIA Members.

5) TAXATION REFORM

Taxation reform continues to have significant potential to impact SME finance and kick-start the Australian economy (eg with Investment Allowances) or influence product selection (eg following the introduction of GST). Recent inquiries – including the House of Representatives Standing Committee on Economics[29] review of the tax deductibility of interest by corporates (including SMEs) provided AFIA with the opportunity to highlight the need for any proposed policy setting revisions to be consulted on with key stakeholders to minimise risk of unintended or adverse consequences.

6) FINANCIAL LITERACY

As noted in the Introduction to the paper, in AFIA's view a key limitation in utilisation of non-traditional bank finance by SMEs to support and grow their businesses is a lack of awareness or understanding by SMEs and their trusted-advisers of the diversity and depth of alternate options for SME finance currently available in Australia. A recent survey of business CFOs found that 88% believed that improving working capital management would boost their company's profitability, but most admitted that they didn't have a plan to make that happen. Given the low interest rate environment and growing number of customised finance solutions tailored to the needs of SMEs, research indicates a clear need for greater advice and communications from bank and non-bank financiers, governments, SME organisations and trusted advisors to the sector to assist improve financial literacy in product offering alternates to match SMEs with the funding option that meets their needs and particular circumstances reflecting where they are at in the SME life-cycle[30]. AFIA welcomes the opportunity to join with the ASBFEO, FinTech Australia and theBankDoctor.org to deliver guidance[31] for SMEs in a way that assists better inform their financing decisions.

REFERENCES

Please refer to details in the footnotes that accompany this paper.

[29]https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Tax_deductibility/Terms_of_Reference
[30] Scottish Pacific Group SME Growth Index March 2018
[31] Commitment detailed in ASBFEO/FInTechAust/theBankDoctor.org Report: Fintech lending to small and medium-sized enterprises Improving transparency and disclosure (February 2018) (Executive Summary pg 7)