FinTechs and the Speed of Financing for Small and Medium Enterprises (SMEs).

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Abstract

Australian small and medium enterprises (SMEs) represent the majority of all businesses, contribute a significant amount to the Gross Domestic Product and provide crucial employment across different industry sectors. Recognising the importance of SMEs around the world, the United Nations General Assembly has nominated 27th of June each year to be Micro-, Small, and Medium-sized Enterprises (MSMEs) Day. Australian SMEs is vast and rapidly evolving sector and the largest client for the banking industry. This paper aims to address some of the issues that surround SMEs' financing in general, from the perspective of the traditional banking sector versus alternative lenders.

Introduction

The existence of and reasons for a "finance gap" in smaller enterprises have been on the agenda for decades, ever since the Macmillan Report (1931) in the United Kingdom, and more recently were investigated in Australia by Watson (2006), Newby and Mahuka (2009), Drever and Hutchinson (2007), COSBOA (2010), RBA (2018). In addition, Schiffer and Weder (2001) asserted that SMEs find accessing finance more difficult than larger enterprises. According to Binks and Ennew (1997), for the vast majority of SMEs, it is unrealistic to expect that funding comes exclusively from internal sources unless large elements of personal equity are available from owners, family or friends. Accordingly, debt finance is typically the major source of external funding for SMEs (Behr & Guttler, 2007; Luo, 2009; Mundial, 2008; O'Donohoe, Hanley, & Lyons, 2006). In most jurisdictions, at this stage, banks/financial institutions, as a group, represent the main source of external debt finance for SMEs.

Traditional banking sector-The incumbents

A well-organised system of SME finance is one that allows them to have access to a full range of financial services and products suited to their unique circumstances (OECD, 2006b). The individual financial needs of small businesses have long been a policy issue in Australia (Hawtrey, 1997). This is confirmed in the research report conducted by CPA Australia (2009) during the Global Financial Crisis, which noted that although there were signs that the supply of external finance to SMEs was stabilising, the credit crunch was still far from over. It was also noted by the CPA Australia (2009) that employment among SMEs was extremely receptive to the supply of finance, as SMEs were facing difficult credit terms/conditions and SMEs with severe cash flow problems tended to reduce their numbers of employees. Recent surveys of SMEs in Australia showed that the availability, speed and cost of finance still remain a major concern (KPMG, 2009; NSW Business Chamber, 2009; Sensis, 2010; RBA, 2018; ASBFEO, 2018).

Earlier investigations by the Vernon Committee confirmed that access to debt finance for the SME sector has been on the agenda for many decades. It was emphasised from the earlier findings that Australian banks/financial institutions' prior negative exposure to the commercial lending sector had a long-term effect on the way banks/financial institutions deal with the SME sector. In addition to this, Carey and Flynn (2005) confirm that changes in credit offered to SMEs depends on the capital requirements approach employed by banks. Since the onset of the GFC in mid-2007, the risk environment has changed significantly. In 2009 business surveys conducted by the Australian Chamber of Commerce and Industry (ACCI) indicated significant concerns over access to bank finance (Australian Bankers' Association (ABA), 2011).

When it comes to debt financing, SMEs have a number of institutions to choose from in the traditional banking sector: commercial banks, building societies, credit unions, commercial finance companies, leasing companies and government funding institutions. The four major banking groups – Commonwealth Bank, Australia and New Zealand Banking Group, Westpac Banking Corporation and National Australia Bank, play the dominant role in the Australian banking sector. This has a substantial impact on the SME sector, as there is evidence that larger banks are less well placed to build close relationships with SMEs (Bannock & Doran, 1990). As such, this suggests that a number of difficulties may arise for SMEs in obtaining funds from banks, including a general tightening in banks' lending standards (Reserve Bank of Australia, 2010b). An Organisation for Economic Cooperation and Development' (OECD) reports (2006a; 2018) confirm this view by suggesting that the difficulties that SMEs encounter when trying to access debt financing could be due to an incomplete range of financial instruments and services.

Since the start of the GFC, banks have been under pressure to provide adequate financing to many vital sectors of the economy, including the SME sector (Reserve Bank of Australia, 2010b). Australian banks and other authorised deposit-taking institutions (ADIs) were affected by the GFC, primarily through its impact on the cost and availability of funding (Reserve Bank of Australia, 2009). The GFC has had a negative impact on SMEs in general, thus reducing their rate of development and increasing the number of bankruptcies (Hodorogel, 2009). According to an earlier KPMG report (2003) and more recent publications by EY(2018), small enterprises want financial service providers to continue to bring new, improved products and services to them, especially now, in light of rapid digital transformation.

The Australian banking system has been subject to considerable change since the Campbell Committee, as part of Australian financial system inquiry (1981) recommended deregulation of the banking system. Banks had to adjust from having a limited risk exposure to being risk-managing, competitive, financial intermediaries (Nielsen, Terry, & Trayler, 1998). According to a Financial Stability Review report conducted by the RBA (2009), borrowing by businesses from banks has been declining since late 2008. This has reflected both reduced demand for credit in the current environment and, to some extent, tighter lending standards (Reserve Bank of Australia, 2009). Credit risk is a critical factor in the management of a commercial bank, especially high risk of unsecured lending to the SME sector (RBA,2018). Banks have raised their concerns about an impact of strict prudential capital requirements when lending to SMEs and resulting loan products which are in many cases prompting to have property pledged as collateral (Productivity Commission, 2018).

Banks' cautious approach to SME lending can be supported by abnormally high SME failure rate, little or no collateral, inability to realistically assess SME creditworthiness and high administrative costs (Haron & Shanmugam, 1994). The other significant factors that affect bank lending to SMEs are their lack of credit history and inadequate risk management and information systems (Ulst & Raa, 2003).

The existence of financial constraints/gaps in the SME sector has been questioned in various research studies (Edwards & Turnbull, 1994; Hyytinen & Vaananen, 2006). It was the Bolton report in 1971 that asserted that there was no scarcity of finance for small businesses, yet small business owner-managers have persisted in complaining of competitive disadvantage due to their inability to obtain finance (Edwards & Turnbull, 1994). There is no universally agreed definition of the "finance gap", but the basic interpretation of this term means that a high proportion of SMEs cannot raise required finance from banks/financial institutions, capital markets or other providers of finance (OECD, 2006b). SMEs' financial constraints represent unsatisfied demand for external finance, as explained by Hyytinen and Vaananen (2006).

According to a research report completed by COSBOA (2009), at least two-thirds of SMEs lending was secured against a residential property, and the same requirements were applied for retail mortgage lending. Also, there was a wide gap between small and large business lending rates. This was also questioned by the Australian Bankers' Association (Australian Bankers' Association (ABA), 2011), as a leading topic in small business finance for quite some time has been the access of SMEs to finance and, to a much lesser degree, the interest rate payable on those loans. According to the latest summary of the discussion on small business finance published by RBA (2012) before the onset of the GFC, the insufficient level of risk had been priced in SME lending arrangements. Thus, the rise in the interest rates charged on small enterprise loans confirms recognition of higher risk in small enterprise lending.

The Economics References Committee of the Senate (2010) emphasised that small enterprises will benefit from a competitive finance market, and therefore, force banks/financial institutions to make the market more competitive. In addition, the committee urges the Australian Securities and Investments Commission to create a small business portal with online tools for small businesses that could articulate details pertaining to small business credit and include details about banks/financial institutions. This is expected to be of great benefit to the SME sector, as small and medium-sized enterprises have considerable gaps in the information and skills needed to access and obtain external finance. This was supported by Tucker (2003) because it is necessary to determine the awareness of the range of financing sources available to the SMEs, which will allow promoting business growth.

A number of Australian private and government organisations surveyed SME owner-managers and investigated current business lending arrangements (Australian Bureau of Statistics (ABS), 2012; Commonwealth of Australia, 2010; Reserve Bank of Australia, 2012).

With the commencement of the GFC in mid-2007, the risk environment changed considerably, and banks/financial institutions had to re-evaluate risks associated with SME lending (Australian Bankers' Association (ABA), 2011).

In 2009, business surveys reported high concerns associated with access to bank finance, as many SMEs had primarily relied on bank finance (Australian Bankers' Association (ABA), 2011). Many smaller enterprises continue to report difficulties with accessing finance (RBA,2018). Australia is currently exposed to the historically low-interest-rate environment, but smaller enterprises continue to pay higher interest rates on loans in comparison to large businesses. In the recent bulleting published by the RBA (2018) it was noted that banks are not providing sufficient financing for start-ups unless real-estate is pledged as collateral.

There were a number of official inquiries into the Australian banking sector over the decades. In 1935 the Royal Commission on Monetary and Banking Systems followed by Financial Systems Inquiries Keith Campbell (1981) followed by Stephen Martin (1991) and the final inquiry completed by Stanley Wallis (1997) The Murray Inquiry (2014) provided additional recommendations for the reforms in the financial services industry. The latest Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019) revealed a number of issues related to banks' products, services, fees. Therefore, customers' trust in the traditional banking sector shows a declining trend. As a result, alternative lenders/fintechs do have an advantage with an opportunity to target SMEs' unmet financial requirements.

The Liberal-National Government has introduced a $2 billion Australian Business Securitisation Fund (2018) with a further plan to establish an Australian Business Growth Fund. The ABSF will invest up to $2 billion in the securitisation market, thus directing additional funding to smaller banks and non-bank lenders for them to lend to small enterprises on more competitive terms. The Australian Business Growth Fund will be aimed at providing longer-term equity funding to small enterprises.

Alternative Lenders-FinTechs

The alternative finance market has demonstrated a dramatic increase in the monetary value over the past few years (Cambridge Centre for Alternative Finance, 2017). Australian Securities and Investment Commission further confirms that in the 2016-2017 financial year, fintech lending platforms provided loans close to US$225 million. The demand from SME owner-managers is supporting the growth of the alternative lenders with SMEs five times more likely to use non-bank lending options (Scottish Pacific SME Growth Index, 2018).

Fintech lenders are characterised by online presence and usage of Artificial Intelligence (AI) and technology to provide various forms of finance to individuals and businesses. Fintechs quite rapidly gained popularity among SMEs due to a quick and easy process of lodging applications, fast turnaround times, online presence and access to unsecured loans, which do not require a property to be pledged as security for a loan, contrary to the traditional banks. Alternative lenders are challenging the traditional banking sector by tapping into the vast SME sector and providing high speed of accessing finance. For SMEs, especially time is the crucial factor in the financing process in current fast-paced market conditions. Fintechs do charge higher interest rates than banks due to a higher risk exposure (no real estate property pledged as collateral) but will require a personal guarantee from the owner/s of the business (Australian Small Business and Family Enterprise Ombudsman, 2018).

FinTech Australia in collaboration with Ernst and Young Australia initiated back in 2016 the first Census on the Australian fintech industry. The Ernst and Young Fintech Australia Census 2018 sourced its data from responses to 151 online surveys with fintech companies, 12 interviews and fintech research reports. The Fintech Australia report (Fintech Australia, 2018) identified five pillars of the fintech ecosystem

1) Talent: a shortage of skills, especially in engineering and software applications.
2) Capital: equity crowdfunding supporting access to capital for start-ups with the dominant share attributable to fintechs.
3) Demand: an upward trend from consumers embracing digital financial products and services.
4) Policy: continued support from the government with the Open Banking regime launching its first stage from 1 July 2019.
5) Environment: fintech founders have emphasised the importance of having access to a strong support network with hubs and accelerators.

The majority of fintechs are located in the state of NSW (55%), followed by the State of VIC (25%) and QLD (12%). 41% of fintechs identified SMEs and/or other start-ups as their end customer. The number of fintechs operating in Australia is approaching 700. Fintechs are finding it difficult to form partnerships with banks and other financial institutions. Predominantly males (81%) are the founders of fintechs with females accounting for 28% only in 2018. The vast majority of fintech founders have a strong educational background with 55% having a postgraduate degree, and 32% have an undergraduate degree. The 2018 EY Fintech Australia Census has also confirmed that the majority of fintech businesses are over three years old, have reached the post-revenue stage and on average employ eight permanent full-time employees. The Census report acknowledges that there has been a change in focus for fintechs highlighting that payments, wallets and the supply chain, lending are on the main agenda.

Data gaps/shortage in the Australian regime have prevented fintechs/alternative lenders to further increase share in the small business lending market (RBA,2018). Fintechs are now given new opportunities in Australia's regulatory environment with the upcoming open banking regime, which is launched in the first implementation stage on 1 July 2019. This means customers will have control over sharing their information/data with and give consent to use your data for specific purposes. At this stage from 1 July, customers are given control over data that relates to their credit and debit cards, transaction and deposit accounts. However, the mortgage data will only be available next year by 1 February 2020. Personal loans, business loans, consumer loans and overdrafts will be available by 1 July 2020. The aforementioned timeframes apply to major banks only, and all non-major banks will require a participation a year after.

Conclusions and direction for future research

Fintechs/alternative lenders can potentially disrupt the financing options for SMEs. World of Open Banking, Application Programming Interface (API) and shared data can expose both providers and users of funds to a wide range of fully digital financing instruments/products. A recommendation for future research is to investigate and to re-evaluate the traditional sources of revenue in the presence of Open Banking API and evolving technology in general.

- What is the effect of artificial intelligence and process automation on servicing SMEs financing needs?
- What are the costs and benefits of partnerships between the fintech lenders and traditional banks?
- Is the banking sector suited to having partnerships rather than market competition with fintechs?

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