Regulation impact statement – Australian Business Securitisation Fund

Contents

1. The problem ... 1

1.1 SME access to finance ... 1

1.2 Funding for SME lenders ... 3

2. Case for government action/objective of reform ... 5

3. Policy options ... 6

3.1 Option 1 – status quo ... 6

3.2 Option 2 – address market infrastructure gaps ... 6

3.3 Option 3 –establish an Australian Business Securitisation Fund ... 6

4. Cost benefit analysis of each option/Impact analysis ... 7

4.1 Option 1 – status quo ... 7

4.2 Option 2 – address market infrastructure gaps ... 7

4.3 Option 3 – establish an Australian Business Securitisation Fund ... 10

5. Consultation plan ... 12

6. Option selection/Conclusion ... 14

7. Implementation and evaluation/review ... 14

8. Appendix: Costing assumptions ... 16

Option 2 – address market infrastructure gaps ... 16

Option 3 – establish an Australian Business Securitisation Fund ... 16

1. The problem

1.1 SME access to finance

SMEs are a key driver of activity and growth in the Australian economy. According to the Australian Bureau of Statistics (ABS), in 2016-17 there were over 2.2 million small and medium enterprises (SMEs) (those employing up to 199 employees) in Australia, accounting for around 68 per cent of private sector employment.[1]

Overall, SME conditions and confidence continue to be strong. However, there are concerns about SME access to finance, the interest rates charged and the terms on which they can access finance.[2] New and quickly growing businesses are more reliant on external finance compared to large and established businesses, but they are finding it more difficult to access. This can hamper the growth of SMEs, prevent the formation of new SMEs or lead to the failure of SMEs, which has significant ramifications for the wider Australian economy.

There is evidence that some SMEs do have adequate access to finance. For example, ABS data shows that, in 2016-17, nearly 90 per cent of SMEs that applied for debt finance were successful.[3] However, this data does not take into account SMEs that perceive they have a low likelihood of success in obtaining finance and as a result do not apply.

This is supplemented by other data which suggests that SMEs perceive that the relative ease of accessing finance has recently declined. The Sensis Business Index September 2018 survey suggests that 31 per cent of existing SMEs that have tried to access finance found it relatively hard. The survey uses the same definition as ABS for SMEs and respondents were able to select from three options: relatively easy, average and relatively hard. Similarly, the RBA Governor has recently expressed concerns about a tightening in the supply of credit to small business.[4] The fact that many SMEs often resort to personal credit products such as credit cards, which is the most commonly used form of debt finance, also raises concerns about access to more appropriate and affordable business finance.[5]

There are also concerns about the terms SMEs have to accept when they are able to access finance. Recent research by the RBA indicates that banks are reluctant to extend finance without real estate as collateral. However, many entrepreneurs may not have sufficient equity in their home or own a home at all. Home ownership rates for those aged 25 to 34 have fallen by more than 30 per cent over the past 25 years and the continued focus on residential property as collateral, particularly for authorised deposit-taking institutions (ADIs), will increasingly inhibit SME lending.[6] Businesses find it difficult to borrow more than around $100,000 on an unsecured basis to support their day-to-day

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[1] Australian Bureau of Statistics 2018, *Selected Characteristics of Australian Business*, cat. no. 8167.0; Australian Bureau of Statistics 2018, *Australian Industry*, cat. no. 8155.0

[2] Connolly and Bank 2018, 'Access to Small Business Finance', *Reserve Bank of Australia Bulletin*, September 2018

[3] Productivity Commission 2018, *Competition in the Australian Financial System*, p 438

[4] Remarks by Dr Philip Lowe at the Committee for Economic Development of Australia, reported in John Kehoe and Peter Ker 2018, 'RBA's Philip Lowe warns on bank scandals, overkill risk',, *Australian Financial Review*, 20 November 2018, available: https://www.afr.com/news/economy/monetary-policy/rbas-philip-lowe-warns-on-bank-scandals-20181120-h184mi

[5] Productivity Commission 2018, *Competition in the Australian Financial System*, p 436

[6] Productivity Commission 2018, *Competition in the Australian Financial System*, p 435

trading activities. In addition to this, businesses report that it is hard to obtain additional finance once they have pledged all of their real estate as collateral.[7]

There are also concerns regarding the interest rates charged on SME loans. Over the past decade, interest rates on small business loans have remained persistently high relative to the cash rate. In contrast, interest rate spreads on corporate bonds issued by large businesses have declined significantly relative to the cash rate.[8] In particular, RBA research has found that smaller companies faced high borrowing rates that have constrained their investment, and that declines in the cash rate have not necessarily flowed through to these borrowers.[9]

Some of the concerns listed above are a natural consequence of SME lending being more risky than other forms of lending. For example, appropriate risk based pricing would still lead to SME loans having higher interest rates than less risky loans such as residential mortgages. Some SMEs are of such high risk they may not be creditworthy, while for other SMEs equity may be a more appropriate form of funding. While it is difficult to definitively state where the balance between appropriate risk management and reasonable access to finance in the SME lending market should be, a number of recent reviews into the industry have suggested that access to SME finance, its cost and its reliance of on residential property collateral could be improved.[10,11] Reasons cited for inefficiency in the SME lending market include a lack of competition (major banks hold 80 per cent of the SME lending market), few alternative lenders of scale, high regulatory risk weights and a lack of granular information in the market for both lenders and borrowers.

A number of recent Government initiatives will improve the functioning of the SME lending market through enhancing the quality and availability of information, for example Open Banking and comprehensive credit reporting (CCR). Open Banking allows businesses to develop new services and products tailored to customers' needs and customers to have greater access to data held by their banks on them. Comprehensive credit reporting gives lenders access to a deeper, richer set of data, encouraging competition for small businesses and retail customers with positive credit histories. APRA is also undertaking a program of work to examine the regulatory risk weights applied to SME lending.[12]

However, these policies may not fully address the competition issues in the SME lending market. A problem they do not address is the lack of competitive funding sources for small, non-bank SME lenders. Much like the lending to SMEs, part of the reason for this lack of competitive funding is that small SME lenders are riskier than other financial institutions such as banks, and newer SME lenders do not have sufficient data on their credit writing performance. However, small non-bank lenders in adjacent markets, such as the auto loan and residential mortgage market, are able to access competitive funding using the securitisation market. The proposed Australian Business Securitisation

[7] Connolly and Bank 2018, 'Access to Small Business Finance', *Reserve Bank of Australia Bulletin*, September 2018

[8] Connolly and Bank 2018, 'Access to Small Business Finance', *Reserve Bank of Australia Bulletin*, September 2018

[9] Hambur and La Cava 2018, 'Do Interest Rates Affect Business Investment? Evidence from Australian Company-level Data', *RBA Research Discussion Paper*, No 2018-05

[10] Productivity Commission 2018, *Competition in the Australian Financial System*, p 442

[11] Connolly and Bank 2018, 'Access to Small Business Finance', *Reserve Bank of Australia Bulletin*, September 2018

[12] Australian Prudential Regulation Authority 2018, Media release: APRA begins consultation with ADIs on revisions to capital framework, 14 February 2018, available: https://www.apra.gov.au/media-centre/media-releases/apra-begins-consultation-adis-revisions-capital-framework

Fund (the Fund) should work to complement the work of APRA and the Open Banking and CCR reforms in increasing competition for SME lending and improving access to finance for SMEs.

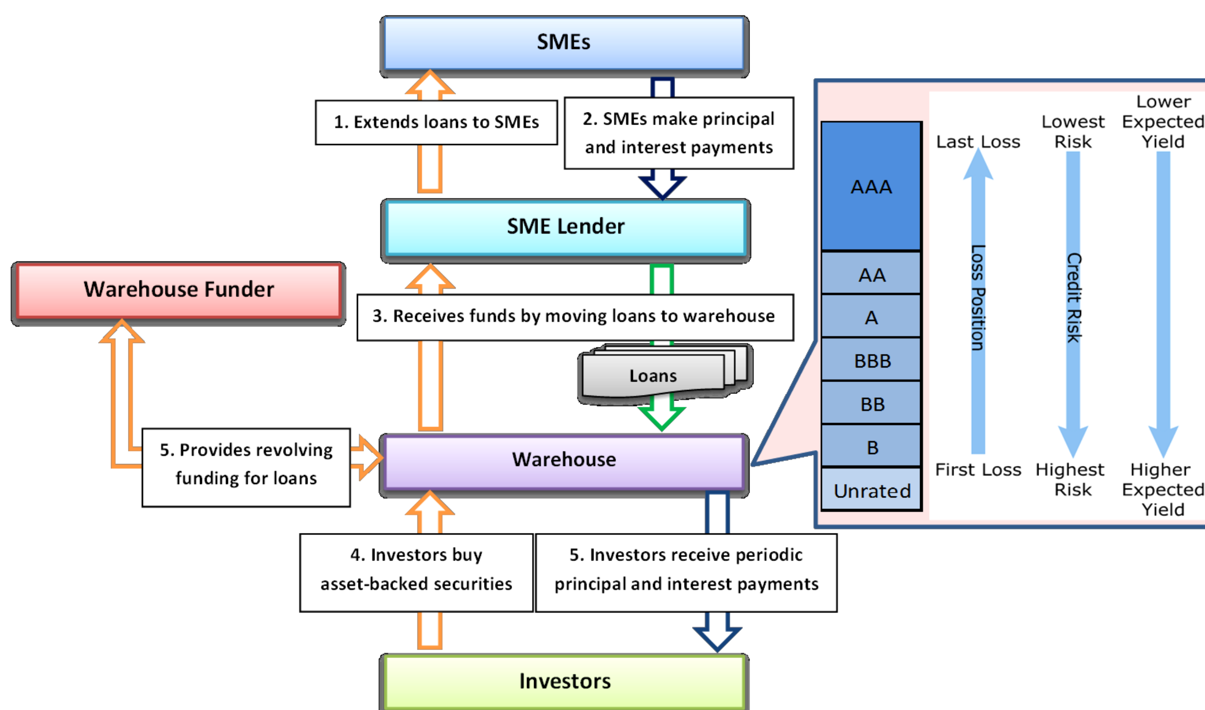
1.2 Funding for SME lenders

This Regulatory Impact Statement (RIS) is focused on assisting the development of the funding market for SME lenders, to provide greater capacity for these lenders, including fintechs, to lend to SMEs. This in turn should increase competition in the SME lending market, which should improve access to finance for SMEs and improve the terms on which they can access finance.

The major banks hold 80 per cent of the SME lending market.[13] Other lenders include smaller banks and non-banks. Non-banks are a small part of the market but are growing quickly and are an increasing source of secured and unsecured SME loans, competing with the major banks and extending finance to previously underserviced markets, often with improved terms such as faster loan approval timeframes. But they themselves face impediments, including obtaining funding from the market at a competitive price.

Lenders obtain funding from a range of sources including equity, deposits and corporate debt (for banks), bank debt (for non-banks) and securitisation and warehousing. Securitisation is a method of funding whereby the cash flows from illiquid assets, such as loans, are packaged into tradeable debt securities that are generally tranched (but need not be tranched), with each tranche having different risk characteristics. The cash flows from the underlying loans are used to make interest and principal payments to investors in the securities. These securities often only have recourse to the underlying assets, with generally no recourse to the originator of the assets. Securitisation may be undertaken on a warehouse or term basis. Warehouses are securitisation facilities that allow a lender to fund loans until they have built up a large enough pool and track record to refinance them into the term securitisation markets.

Diagram 1: Generalised structure of a warehouse facility



[13] Productivity Commission 2018, *Competition in the Australian Financial System*, p 442

Securitisation is an important source of funding for non-bank lenders and has been an important driver of competition for residential mortgages.[14] It allows unrated or lower-rated lenders to issue higher-rated debt instruments, providing them with access to new investors and a potentially cheaper source of domestic debt funding to enable them to compete with the major banks. If non-bank lenders and smaller banks have a larger pool of funds at their disposal, they can extend more credit to SMEs.

While the residential mortgage-backed securitisation market in Australia is well developed, the securitisation market for SME loans in Australia and other countries is small. Total securitisation outstanding in Australia is currently around $133 billion.[15] Residential mortgage-backed securities (RMBS) represent more than 80 per cent of this total, while the remainder is mostly comprised of securitised loans collateralised by automobiles or other real assets.

The market for SME securitisations backed by secured loans is relatively small, with around $4 billion of deals since 2016. The securitisation market for unsecured loans is at an embryonic stage, consisting of a handful of small private deals, often with a single investor, totalling around $130 million structured in the past few years. This is in contrast to the more developed securitisation markets, where deals are generally larger, publicly marketed, have a number of investors across several tranches and for which there is some liquidity in the secondary market. In addition, a small number of commercial and investment banks and other funders provide warehouse facilities to several emerging SME lenders.

Unlocking the securitisation market for SME loans would allow smaller banks and non-bank lenders to compete more effectively against the major banks. Better access to funding will support them to grow and generate economies of scale. This would lead to reduced prices in the market, increased diversity of SME lending products and increased access to finance for SMEs. The government intervention could also lead to cheaper funding, which may also potentially lead to reduced prices in the market.

Recent consultations with market participants indicate there are constraints on the development and depth of SME securitisation markets, particularly for deals backed by unsecured SME loans. Some of these are inherent and reflect the nature of SME lending while others are temporary and may diminish with the development of the market. Constraints include:

- Lack of homogeneity of SME loans and lack of historical default data for individual lenders, particularly new SME lenders. These make it more challenging and costly for warehouse providers, term investors and ratings agencies to assess the quality of an SME lender's credit policies and credit writing, and therefore willingness to provide funds.
- A lack of scale and standardisation of deal structures, which increases costs for originators and investors. For originators, the costs of putting together a term securitisation deal mean that minimum issue size is in the order of $50-$100 million. Newer SME lenders must find other sources of funding to enable them to build up their loan books to a size large enough to issue a term deal, which can be challenging and constrain their growth. For investors, there are significant costs associated with conducting credit analysis and other due diligence which can be prohibitive when they do not expect there to be a consistent pipeline of deals coming to market across which to spread costs.

[14] Reserve Bank of Australia 2014, *Submission to the Financial System Inquiry*, p 160
[15] Australian Bureau of Statistics 2018, *Assets and Liabilities of Australian Securitisers*, cat. no. 5232.0.55.001

- Significant first mover costs. The first few SME lenders to access the securitisation market will have to undertake a significant amount of technical and legal work to develop appropriate structures for the underlying SME loans. They will also have to undertake significant work to help other parties such as credit rating agencies, regulators and investors to become comfortable with the new asset class, including ensuring they have data of a sufficient quality to satisfy these parties' requirements. Firms that enter the market later will be able to free-ride off this work. This means the cost of issuance should decline over time, but it also means lenders have incentives to delay their entry into the securitisation market, which may hamper the market's development.

- Related to the above, a lack of investor awareness of and familiarity with SME securitisation as an asset class means investors may prefer to remain in more well-known securitisation classes such as RMBS, or alternatively if interested in higher risk sectors consider investments such as private equity or venture capital.

- A lack of SME awareness of smaller and non-bank lenders, or the need to obtain related services such as transactional banking, payments terminals or cash handling, can hinder the growth of new SME lenders and thus their ability to achieve the scale required to enter the securitisation market.

2. Case for government action/objective of reform

The SME securitisation market currently suffers from self-perpetuating lack of scale: sporadic deals and low issuance volumes mean that potential investors are reluctant to invest the resources needed to enter the market (e.g. to conduct due diligence), while the issuance pipeline is constrained by the limited participation of potential investors. Improvements to market infrastructure, such as in the areas of data, scale and standardised structures, could address some of the constraints identified by stakeholders. To date, the market has struggled to address these constraints as there are a diverse range of players with different interests that have been unable to successfully coordinate. Government, as an external player, could bring these participants together to determine and implement the best options to address infrastructure constraints.

However, addressing infrastructure constraints alone may not be sufficient to overcome the lack of scale in the SME securitisation market. The intervention of the government as a longer-term investor who is willing to do due diligence despite the small scale of the market and is willing to be a flexible investor in potential deals has the potential to break this self-perpetuating cycle. A flexible investor would be one who is willing to have their share of the final deal scaled to what works best for the issuer and other investors. This would help resolve the coordination problem faced by many issuers, where they do not wish to develop a deal until they are certain there will be sufficient investor interest while investors will not want to put in the work to look at a potential deal until they are certain it will go ahead and they have a good chance of getting the slice of the deal they are seeking.

Solving this coordination problem and breaking the self- perpetuating lack of issuance would accelerate the development of the securitisation market which would unlock a new, sustainable and cheaper funding source for smaller lenders. This will in turn allow these smaller lenders to compete more effectively in the SME lending market, which should improve borrowing conditions for SMEs in the long term. Increasing scale in the market through government investment may also assist in improving data availability and standardisation, regardless of any specific measures to address infrastructure constraints. The government can also provide funding at less than prevailing market

rates to subsidise the growth of the market and thus help sufficient scale to be achieved. However, the size of any subsidy would need to be carefully managed to avoid being too large as to crowd out private sector investors.

3. Policy options

3.1 Option 1 – status quo

Under this option, the Government would not intervene in the securitisation or other funding markets for SME lenders. SME lenders would continue to access funding from existing private sector sources, including equity capital, corporate debt markets, warehousing, other loans from banks, other financial institutions, and the small securitisation market.

3.2 Option 2 – address market infrastructure gaps

Under this option, the Government would intervene to improve SME securitisation market infrastructure.

These options could focus on addressing some of the inherent constraints on the development of the securitisation market, such as the lack of homogeneity of SME loans and limited historical default data to inform market pricing. Other interventions could target constraints that arise due to the market's embryonic stage of development, including low awareness by investors and lack of standardisation of deal structures. While some constraints may lessen over time, the cost of some interventions (such as improving data availability) may be beyond the reach (and interest) of individual market participants, while the benefits would accrue to market participants at large.

Enhancing the infrastructure could involve:

- Creating a centralised repository of data on SME loan performance, available to investors, issuers and ratings agencies;
- Developing standardised risk models for SME loans; and
- Creating a standardised SME securitisation structure.

This option would not involve the creation of a fund to invest in SME securitisations.

3.3 Option 3 –establish an Australian Business Securitisation Fund

Under this option, the Government would establish an Australian Business Securitisation Fund (the Fund) to facilitate access to securitised funding and related warehouse funding by lenders (banks and non-bank lenders) to SMEs, with a Government balance sheet exposure of up to $2 billion.

A number of international jurisdictions have used government balance sheets, such as via credit enhancement or direct purchase, to support their SME securitisation markets. [16] These international jurisdictions include the European Union, the United Kingdom, the United States, Canada and Japan.

[16] Treasury conducted desktop research on what other countries did including the United States, the United Kingdom, Canada, Japan and the European Union.

The Fund would be underpinned by legislation and operated from within the Australian Office of Financial Management (AOFM) on delegation from the Treasurer. The Fund would be administered in accordance with the legislation and any other government directions.

The Fund would be run by the AOFM working within existing market infrastructure, specifically:

- The AOFM would partially fund privately run warehouses for unsecured and secured SME loans via the purchase of securities issued by them. The Treasurer will provide the parameters and constraints within which the AOFM would operate via an investment mandate, which would include mandating the acceptable level of credit risk with consideration for protecting the Commonwealth's balance sheet and managing a smooth exit from the market over time;
  - The AOFM would use private sector warehouse facilities and these entities would remain responsible for operating the warehouses and the eventual 'term out' of the underlying SME loans into the securitisation market;
- The AOFM would also buy and hold securitised SME loans in those segments of the market where there are identifiable market gaps or to support the market for securities. This would enable SME lenders to recycle funds from repaid loans to extend new loans.
- The maximum size of an eligible underlying SME loan will be $5 million.
- An investment mandate would be issued, outlining a positive target return benchmark, after costs and any credit losses have been accounted for.
- The performance of the Fund will be reviewed to allow the Government to consider whether the policy is having its intended effects on the SME securitisation market and SME lending.

4. Cost benefit analysis of each option/Impact analysis

4.1 Option 1 – status quo

The problem of an underdeveloped SME securitisation market would not be addressed.

The advantages of maintaining the status quo are that SME lenders would not have any additional obligations placed on them, either directly or indirectly via any form of government intervention and current investors in the warehouse and securitisation market would face no change.

The disadvantages of maintaining the status quo are that smaller SME lenders, including non-bank lenders, would continue to face high costs and barriers in accessing securitisation markets, and hence continue to face limitations in their competitiveness and ability to extend credit to SMEs.

As this option would maintain the status quo, there are no regulatory costs associated with this option.

4.2 Option 2 – address market infrastructure gaps

Constraints in the development of the SME securitisation market would be partially addressed through interventions to improve market infrastructure.

The advantages of this option are:

- Improving market infrastructure would directly address some of the constraints identified by stakeholders, namely the standardisation of structures, quality of data and some first mover costs.
- It could assist the development of the market, by providing the foundation on which the market could grow without direct Commonwealth financial investment or support.

Beneficiaries would include lenders who raise funding or would like to, using this channel, market participants and intermediaries such as banks, law and advisory firms and other service providers, prospective investors such as fund managers, and regulators. SMEs would benefit from increased availability of finance over time.

The disadvantages of this option are:

- Improving market infrastructure would take some time to take effect, as interventions would need to be identified and implemented.
- There would be challenges associated with coordinating the disparate market and government participants in an area where no one body has primary interest. Data collection is limited and may be challenging, and appropriate standards and ongoing ownership need to be determined.
- Market participants may face additional regulatory costs, depending on the nature of infrastructure improvements, for example, if the centralised repository of data was established and there were obligations to provide information.
- This intervention would not address many of the constraints identified by market participants. It would not directly help lenders build scale or address their uncompetitive funding costs. It would lower some first mover costs but not others, such as the costs to engage with investors and other market participants to get them comfortable with the new asset class. Finally this option may not be enough to get investors to engage with the market – especially if it continues to suffer from self-perpetuating lack of scale.

There are also a number of risks associated with this option:

- Some market participants may choose not to participate in the development of risk models or standardised structures or choose not to contribute data to a centralised database. These participants may choose to free-ride off the efforts of others or try to gain an informational advantage by keeping their own data private while the rest of the market makes theirs public. This could lead to undesirable market distortions or lead to participating market participants withdrawing from the program.
- There is also a risk that the government may misidentify the market's requirements and create infrastructure that is unfit for purpose. This risk may be exacerbated if only a limited number of market participants choose to assist the development of the infrastructure, which may be driven by the risks described above. There is also a risk that the development of infrastructure would take a sufficiently long period that it would be unfit for purpose by the time it is complete. This is of particular note given the growth in the market the policy seeks to help facilitate.
- There is also a risk that privacy concerns may hamper the development of the database. If a detailed database is sought then personally identifiable data is likely to be included, which

would necessitate requirements like strictly monitoring data use and carefully restricting access to the data. The requirements to ensure privacy may be onerous and deter market participants from using the database. If less detailed data is included then this would lower the barrier to accessing the data, but may diminish the usefulness of the database.

The risks above could eventuate as a budget and financial risk for Government, with wasted resources for little benefit and/or a risk that the infrastructure build may cost more than originally anticipated.

These risks could be managed with regular and detailed consultation with market participants. Strategies for managing these risks would also be refined as detailed plans for the infrastructure are developed and the degree of risk became clearer.

Regulatory costs

Should the Government implement Option 2, additional regulatory costs would be imposed on market participants. These are expected to be of low to medium range and reflect:

- upfront IT and systems work that would be required to ensure that SME lending data is captured in a form consistent with the agreed data standards, and work to transform historical data for a defined period to meet the same data standards;
- ongoing costs related to providing the data to the repository on a regular basis; and
- an assumption that any data reporting requirements would apply to all, or a significant majority of, SME lenders in Australia in order to ensure any resulting analysis or modelling has appropriate statistical robustness.

Costs for potential other elements, such as developing standardised risk models and a standardised securitisation structure are expected to primarily relate to consultation costs to develop agreed standardised approaches. These are not considered to be regulatory costs for the purposes of this RIS.

Using the regulatory burden measurement framework, it has been estimated that Option 2 would increase compliance costs by $3.8 million per year. This estimate has a low level of certainty, as detailed scoping and development would be required to determine the exact nature and form of data to be collected and consequential obligations that would be placed on market participants. A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

Table 1: Regulatory burden estimate (RBE) table (see Appendix for further detail)

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$3.8 million	-	-	$3.8 million

4.3 Option 3 – establish an Australian Business Securitisation Fund

The problem of an underdeveloped SME securitisation market resulting in gaps in access and pricing of SME loans would be addressed through the Commonwealth establishing the Fund to invest in securitised assets and provide financial support for SME warehousing.

The advantages of this option are:

- Announcement of a government commitment to financially support the market may help improve how potential investors perceive the market, prompting them to consider entering the market.
- Government financial commitment would potentially broaden the investor pool to include those with less risky investment mandates.
- Government financial support would counteract first mover costs for SME lenders and thus improve their incentives for entering the securitisation market, in turn stimulating greater market development.
- The capacity to consider subsidised pricing in some securitisation deals may make it economical to issue smaller deals. This may help build the profile of smaller lenders and allow them to spread the fixed costs of issuance across more deals. Providing a subsidy should not be required in all cases and the subsidy required to achieve these aims should be small.
- It will provide additional opportunities for other investors to purchase securities backed by SME loans. Over time, it will lead to the establishment of a better informed, more liquid market of greater scale for investors who may not currently invest in the market due to its limitations.

The disadvantages of this option are:

- Increased financial risk for the Commonwealth arising from any market intervention. The Government would be exposed to uncertain financial returns as well as the potential loss of funds invested, reflecting credit risk arising from potential defaults on underlying SME loans. This risk varies across the economic cycle. For example, RBA data shows that non-performing business loans written by banks peaked at around 3.5 per cent during the GFC and current levels are below 1 per cent.
- Increasing government indebtedness reduces flexibility during times of crisis and leaves governments exposed to changed conditions in funding markets and increased market and rating agency scrutiny of the sustainability of the Government's budget position.
- If not implemented carefully, a risk of displacing existing investors, by limiting opportunities to invest and/or through the market adapting to government investment preferences which may not be compatible with private investor needs. This could cause these parties to exit the market, leaving it in an unsustainable position once the Government seeks to wind up the Fund. This risk would be borne by lenders utilising the market to finance their loan book.

It is unavoidable that the Fund would be exposed to financial risks to achieve its objectives, commensurate with the nature of the investments to be made. The securitisation process, through

the use of tranching and pooling of loans, will greatly reduce the Fund's exposure to credit risk from individual SME loans. Furthermore, these risks would be limited to the degree necessary to achieve the Fund's policy objectives through the application of the investment mandate for the Fund and other features of the Fund's design, such as:

- a prohibition on investing in 'first loss' securities, which is the tranche of a securitisation that is the first to suffer loss should the underlying loan pool perform worse than expected. There would also be an expectation that this tranche is held by the originator of the loans, in order to align investor and lender incentives to promote high loan quality. This feature will be important to ensure the Government's presence as an investor does not give rise to moral hazard in loan assessment processes;
- the requirement for an appropriate risk management framework to be developed, which would include the approach to be taken for informing decisions on investments that do not have the benefit of an external credit rating;
- a requirement for the Minister to consider, prior to making a decision to delegate investment powers, whether the person has appropriate qualifications or expertise to exercise the functions; and
- measurement of the target rate of return for the fund is inclusive of any losses arising from SME loan defaults, to appropriately reflect the underlying risks of the market in the Fund's operational target.

In relation to market risk, utilising existing market infrastructure and requiring co-investment will reduce the risk that the Fund crowds out the private sector. The investment mandate requires that the potential for effects on other current or prospective securitisation market participants must be considered, with the aim of deepening the securitisation market for SME loans and encouraging greater private investor participation in the market over time.

Dialogue with market participants is intended to allow the Fund to increase the level of co-investment and thus enhance the impact of the Fund's own investment while mitigating the risk of crowding out the private sector. To assist in the effectiveness of this dialogue:

- the investment mandate requires a high level of transparency through the publication of information relating to investments on a timely basis following settlement; and

  the legislation provides for two reviews (at 2 years and 5 years) of the effectiveness of the Fund in achieving its objectives.

Regulatory costs

Should the Government implement Option 3, additional regulatory costs would be imposed on SME lenders. These costs are expected to be low, reflecting that the AOFM would operate within existing infrastructure and only partially fund existing or new warehouses or term securitisation deals. SME lenders seeking to raise funds via either of these avenues would incur a range of costs in dealing with private sector investors, whether or not the AOFM co-invested – costs that would be commonly incurred in the course of due diligence and contractual obligations imposed by private investors have not been included.

The additional costs for SME lenders of AOFM co-investment therefore primarily relate to the time required for additional engagement with the AOFM pre-investment and for the period of AOFM's involvement, and additional legal and structuring advice costs. The Fund is intended to operate while the SME securitisation market remains in a developmental stage. The reviews provided for in the

legislation and ongoing market liaison will inform Government decisions on the Fund's ongoing role and exit timeframes.

As the Government would not be engaging with SMEs directly, there would be no regulatory costs imposed on SMEs.

Using the regulatory burden measurement framework, it has been estimated that Option 3 would increase compliance costs by $0.1 million per year. A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

Table 2: Regulatory burden estimate (RBE) table (see Appendix for further detail)

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0.1 million	-	-	$0.1 million

5. Consultation plan

The Government undertook a targeted consultation in late 2018 with a range of SME lending and securitisation market participants to understand the current state of the SME securitisation market, constraints on its development and important design considerations for any policies to address shortcomings in the market. Stakeholders consulted included:

- bank and non-bank SME lenders that are either current or potential SME securitisation originators;
- fixed income investors;
- warehouse facility and other securitisation service providers;
- credit rating agencies;
- the Reserve Bank of Australia;
- the National Housing Finance and Investment Corporation; and
- the Australian Prudential Regulation Authority.

The targeted consultation did not involve meeting individual SMEs, which have little visibility of or expertise regarding the securitisation market. The Government has separately engaged with SMEs to understand their experience with borrowing, such as via the RBA small business finance roundtables in 2018, and reviewed the available research and data on access to finance.

Consultation consisted of bilateral meetings and stakeholder roundtable meetings. The engagement allowed Treasury and AOFM to test the efficacy, impacts and regulatory costs of particular investment arrangements. Feedback from stakeholders highlighted the diversity of structures in the SME securitisation market, the importance of not crowding out existing warehouse providers and investors, and the need for flexibility in the AOFM's approach. This feedback was used to develop an appropriate governance structure and investment mandate for the Fund. These discussions also

supported detailed planning for the implementation of the Fund (including its eventual exit from the market in the longer term).

The Government released draft legislation and key elements of an investment mandate for consultation on 21 December 2018. Submissions closed on 16 January 2019. Recognising the short consultation period over the holiday period, Treasury alerted stakeholders to the forthcoming consultation during the abovementioned bilateral and roundtable meetings, and again when the consultation package was released.

A total of 15 submissions (11 public and 4 confidential) were received. Submitters included industry bodies, non-bank lenders and investors. Stakeholders supported the establishment of the Fund to improve access and reduce the cost of finance provided to SMEs but had several fine tuning suggestions to improve the draft legislation.

Stakeholders raised a number of key issues:

- greater flexibility in the phasing of crediting of capital to the Fund to allow the AOFM to adjust to market conditions and deploy capital as appropriate opportunities arise;
- the definition of the SMEs should be included in the legislation rather than a definition based on loan size and the originally proposed loan cap of $10 million could be too high;
- some submissions suggested that restricting investments to securities issued by a trustee of a trust may be inflexible as there are other potential structures such as corporate special purpose vehicles;
- a suggestion that the two-year review be delayed to provide more data on which to assess the performance of the Fund; and
- suggestions on the type of information that should be included in the annual reporting on the Fund.

Minor changes were made to the legislation following consultation to improve its operation, including:

- providing for an additional review after five years of operation;
- reducing the loan cap from $10 million to $5 million;
- allowing for flexibility to invest in non-standard structures by including corporate special purpose vehicles; and
- providing greater flexibility to enable the AOFM to prepare the annual reporting on the operation of the Fund.

While the Government considered the other issues raised by stakeholders, it decided to retain the originally proposed settings. In particular, it was considered appropriate to retain the concept of eligible loans based on the size of loan, rather than defining SMEs directly. There are a number of definitions of small business across Commonwealth legislation drawing on different metrics and no current legislative definition of medium business. A definition based on loan size was considered an appropriate proxy for SMEs that would minimise the potential compliance costs associated with more detailed definitions.

The explanatory memorandum to the legislation was also updated to provide greater clarity on the operation of the eligibility requirements and that the loan size relates to the underlying SME loans.

6. Option selection/Conclusion

Given the relative advantages and challenges presented by each option, Option 3 is preferable and should be implemented to assist the development of the SME securitisation market and improve SME lending conditions. It is acknowledged that the extent of the likely net benefits cannot be quantified due to:

- The complexity of causal factors contributing to the access to finance gap for SMEs and therefore, the extent to which options for intervention in the securitisation market will deliver improvements. However, for the reasons outlined in section 1, it is considered that lowering funding costs for business lenders via a better developed securitisation market is a critical piece of the puzzle, a conclusion which is supported by experience in the residential mortgage market.
- There is also uncertainty associated with the costs and risks of Options 2 and 3, with both inherent uncertainties and also due to lack of information (sections 4.2 and 4.3 refer).

Option 2 would, in principle, provide some valuable benefits. However, the existence of the infrastructure by itself does not address the scale constraint (as outlined in Section 2), and so may not be sufficient for the market to develop and grow to a sustainable level.

Option 3 would directly address this constraint, leading to a higher probability of success in developing of the securitisation market for SME loans and therefore, greater likely benefits. It is also likely to have a more immediate impact on the market, delivering benefits in a more timely way.

As outlined in section 4.3, there are both costs and risks associated with Option 3. However, the financial costs and risks to the Government have been mitigated by requiring a positive target rate of return that incorporates credit losses, and the detailed design features of the investment mandate and legislation in relation to the management of financial risks, utilisation of expertise in decision-making; and requiring a high level of transparency in the Fund's operations. The two reviews of effectiveness (after 2 and 5 years) will allow fine tuning to occur as required, potentially focused on whether the Fund's activities are consistent with the aim of encouraging private investor participation and long-term market development.

In contrast, Option 2 is likely to face considerable practical difficulties of implementation including coordinating the various market players; governance, data integrity and protection complexities and the extra regulatory burden imposed on market participants. There is also a risk that costs could be significantly higher than estimated if the required IT and process work was more extensive than expected and timelines for implementation delayed.

Combining the assessment of benefits, costs and risks, option 3, therefore, is considered to provide the highest net benefit to the community and should be implemented to improve SME lending conditions.

7. Implementation and evaluation/review

Legislation is required to establish the Fund. The AOFM will be responsible for administering the Fund and making its investment decisions.

The Fund will be exposed to credit and other financial risks commensurate with the nature of the investments to be made to achieve its policy objectives. These risks will be managed through the use of a suitable risk management framework that is supported by frequent stakeholder liaison.

Dialogue with market participants will also allow the Fund to increase the level of co-investment and thus enhance the impact of the Fund's own investment while mitigating the risk of crowding out the private sector.

To guide its operation, the proposed investment mandate for the Fund:

- outlines risk mitigation strategies that the Fund will require, such as the development of guidance for assessing credit worthiness of investments, particularly where external credit ratings are not available;
- prohibits investing in first loss securities, which are the tranche of a securitisation that first suffers losses should the underlying loan pool perform worse than expected and will be borne by the SME lender to maintain incentives for good credit decisions; and
- prescribes the Fund's target rate of return, which will ensure that the Fund's investments are allocated to productive undertakings that are expected to at least cover the Government's cost of funding.

Flexibility in the Fund's mandate will help it to better manage these challenges and adapt its approach based on its performance developments in the market.

The legislation establishing the Fund requires that its operation be reviewed two years and five years after its establishment. The reviews must include a review of the effectiveness of the legislation, and therefore the Fund, of meeting the policy objective of the long-term development of the SME loan securitisation market and supporting the availability of more competitively-priced loans for SMEs. A copy of the report must be tabled in Parliament within 15 days of it being provided to the Minister.

As part of the reviews, information would be collected to assess the SME securitisation market development, such as deal volume, deals outstanding and the deal pricing, as well as conditions in the SME lending space, such as loan volume and interest rates charged. Views of industry stakeholders would be sought on the qualitative impact of the Fund in achieving its policy objective.

In addition to the legislative reviews, the AOFM will continue to liaise with stakeholders to refine the Fund's approach and to review its performance. The AOFM's annual report will include reporting on the operation of the Fund, including its financial performance. Treasury will also engage with stakeholders on an ongoing basis to monitor the impact of the Fund on the SME securitisation market and achieving its policy objective.

8. Appendix: Costing assumptions

Option 2 – address market infrastructure gaps

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$3.8 million	-	-	$3.8 million

General assumptions

Details	Estimate
Number of major bank SME lenders	5
Number of other ADI SME lenders	30
Number of non-ADI SME lenders	23
Labour costs (per hour)	$68.79

Regulatory costs

Task	Frequency
Updating internal systems, forms and processes and developing internal policies to accommodate regular data reporting Updating limited amount of historical data to match standardised format	Upfront
Regular data reporting and maintenance of internal systems, policies and processes	Ongoing

Option 3 – establish an Australian Business Securitisation Fund

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0.1 million	-	-	$0.1 million

General assumptions

Details	Estimate
Number of SME lenders engaging with the Fund	12
Number of new deals (annually)	3
Labour costs – lenders (per hour)	$164.50

Labour costs – legal and structuring (per hour)	$460

Regulatory costs

Task	Details
Understanding ABSF	Upfront
Pre-investment engagement with ABSF	Ongoing, per investment
External legal and structuring advice	Ongoing, per investment
Engaging with and reporting to ABSF for term of deal	Ongoing, for term of investment