Breaking the Credit Barrier: Structural Challenges of SME Financing in New Zealand

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Abstract

This paper examines the structural barriers preventing New Zealand's small and medium-sized enterprises (SMEs) from accessing affordable debt. Despite representing 99% of all businesses and a third of national GDP, SMEs face far tighter lending conditions than residential borrowers. Through quantitative scenarios, the paper demonstrates how short loan terms, high interest rates, and restrictive loan-to-value ratios severely constrain cash flows, leading many profitable firms toward financial stress. It also highlights how regulatory incentives—particularly the Reserve Bank's high capital adequacy ratio—encourage banks to favour residential mortgages over business loans. The analysis identifies three key issues: limited understanding of cash-flow dynamics, policy-driven risk aversion among banks, and a feedback loop reinforcing SME credit scarcity. Recommended measures include recalibrating risk weights, strengthening bank verification processes, and launching nationwide financial education initiatives to help SMEs manage debt sustainably and unlock growth potential.

Introduction

Small and medium-sized enterprises (SMEs) form the backbone of New Zealand's economy, representing 99% of all businesses and contributing approximately 35% of national GDP (MBIE, 2017). Despite their importance, SMEs face disproportionately tight lending conditions compared to the residential mortgage market. Restricted access to affordable credit limits their ability to invest, expand, and sustain growth, especially for firms employing fewer than 50 people.

An optimal capital structure is essential for business resilience. Excessive reliance on debt can increase vulnerability, but insufficient borrowing constrains profitability and growth by limiting the firm's capacity to leverage equity and improve return on equity (ROE). Large corporations can balance these pressures by issuing bonds or diversifying funding sources, yet such instruments remain inaccessible to most SMEs due to their limited scale and administrative capacity. As a result, small businesses rely almost exclusively on bank lending, exposing them to systematically more stringent conditions, including higher interest rates, shorter repayment periods, and lower loan-to-value ratios, than those available to households.

This paper examines the structural barriers that prevent Kiwi SMEs from accessing equitable financing and explores how current banking and regulatory frameworks perpetuate this credit imbalance.

Findings and Analysis

Current State

Banks generally offer **principal-and-interest** (P&I) loans, for which borrowers must pay interest and a portion of the principal each month. Under certain conditions (which contacted banks declined to disclose), banks may allow up to five years of interest-only payments (ANZ, 2020).

A typical **residential mortgage** covers around 80% of a house price with an interest rate below 3% (Squirrel, 2020). Most banks can even offer to fund 90-95% of the loan and amortize it over 30 years. Indeed, since May 2020, the Reserve Bank of New Zealand has removed the mortgage loan-to-value ratio restrictions for banks in response to the COVID-19 pandemic (Kiwibank, 2020). In contrast, banks may propose to fund approximately 70% of a **commercial property** (Global Finance, 2020) at 5.5% with a 15-year term (interest.co.nz, 2020). If the business owner seeks to fund 100% of the asset through debt and repay over 30 years, they must typically use their personal residence as collateral (Global Finance, 2020).

For a **business loan,** banks generally agree to fund 50% of the investment at an 8% interest rate with a five-year repayment period (Global Finance, 2020). Once again, business owners must often secure the loan with their personal residence to fund up to 80% of their house value through debt (Global Finance, 2020).

	Residential mortgage	Commercial property loan		Business loan	
			Secured		Secured
LVR	80-95%	70%	100%	50%	80%
Interest rate	2.75%	5.5%	5.5%	8%	8%
Term	30 years	15 years	30 years	5 years	5 years

e.g. owner's house as security

Figure 1: Differences in lending conditions depending on the type of loan.

Impact on Investments

For a given return on assets, the **return on equity** (ROE) will change dramatically depending on the loan-to-value ratio (LVR). A lower LVR implies a higher initial investment and, therefore, a lower ROE (see example below).

Consequently, bank policies impact the firm's ability to develop.

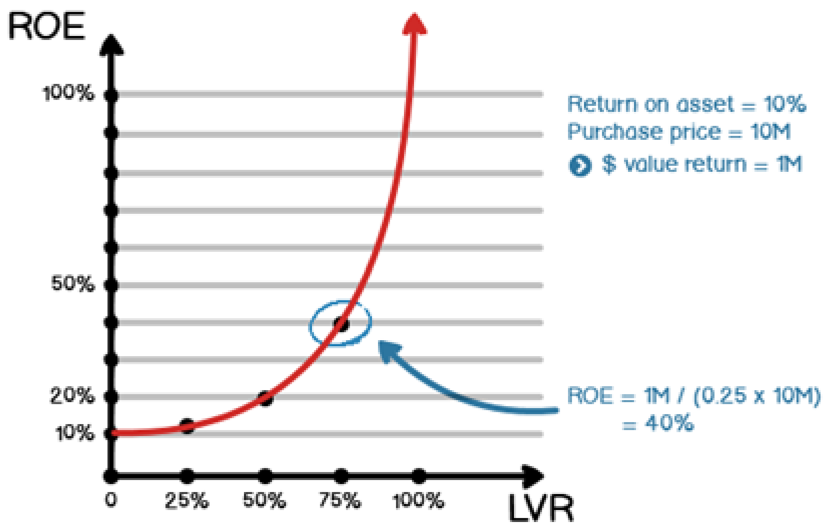

Figure 2: Relationship between the return on equity (ROE) and the loan-to-value ratio (LVR).

However, poor lending conditions have a much more profound effect on SMEs. Understanding the magnitude of this impact requires knowing the difference between **profit and cash flows**.

Impact on Cash Flows

Profit after tax does not necessarily reflect the company's ability to pay its debts. Indeed, it also includes revenues and expenses for which cash has not yet been exchanged. For instance, when a business sells on credit, profit will go up, but the related cash inflow will only occur **later**. Similarly, expenses associated with building up inventory will be missing from the income statement until the goods are sold.

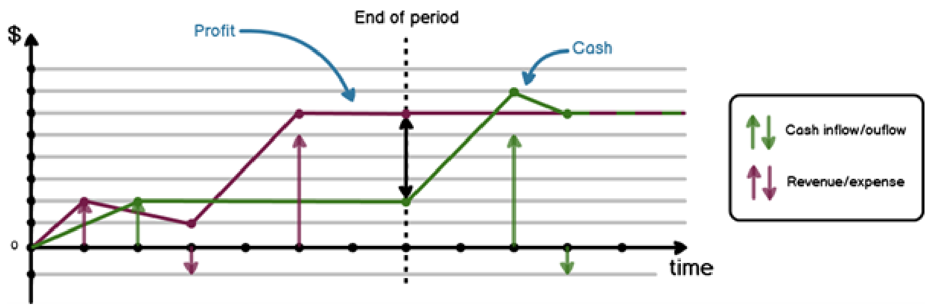

Figure 3: Profit and cash evolution over time.

Furthermore, depreciation in the income statement does not necessarily reflect the cash spent to buy and maintain fixed assets, essential to sustain the business (e.g. computers). Often, it is not a reasonable indication of long-term average capital expenditure.

Therefore, a relevant proxy for available cash flow is defined as follows.

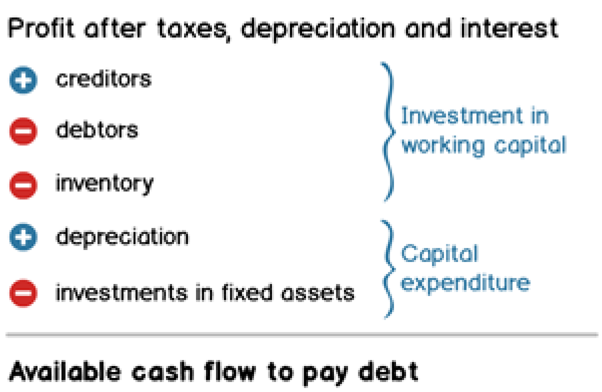

Figure 4: Proxy for available cash flow for principal repayment.

Firms can, consequently, make a profit but still default on their debt. The scenarios below are representative of loan conditions that NZ SMEs typically encounter.

Scenario 1. Buying a business

The bank agrees to partially fund the purchase of a small machinery manufacturing business under the following conditions.

Purchasing price	$375,000
LVR	80% (**secured**)
Type of loan	P&I
Term	5 years
Interest rate	8%

> Assumptions for the simulation: Building up inventory and debtors during the first year, then static business (no growth and, therefore, no further movement in working capital items).

Despite making a profit, the business would struggle to pay its debt, as highlighted by the chart below (see Appendix 1 for calculation details).

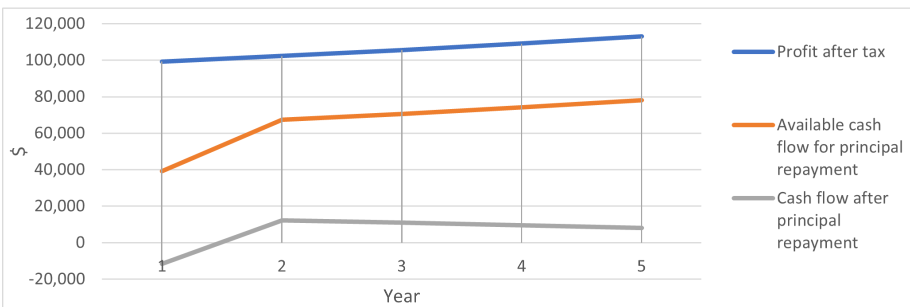

Figure 5: Projected profit after tax and cash flows.

The first year, the company would not have the cash flow to honour its principal repayment. Even if it finds a way to meet its obligations that year (e.g., by limiting its capital expenditure), the business would still be significantly exposed to financial hardship in the subsequent years. Indeed, any unexpected expense (e.g. equipment maintenance) or revenue loss could lead to a default.

More favourable lending conditions would have a positive effect on the company's cash flows, as visible in the following diagram.

Regardless of the loan type and interest rate, a 5-year loan is a significant burden on a business's ability to thrive. On the other hand, a 10-year term would let the company have enough cash flow to grow serenely.

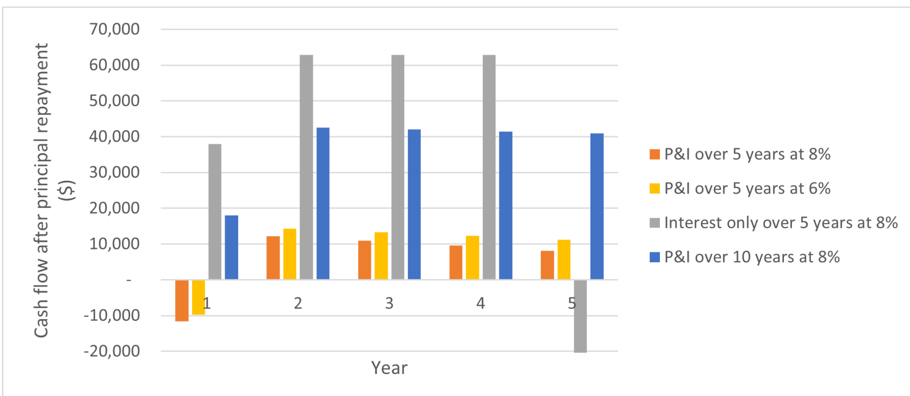

Figure 6: Cash flow after principal repayment under various loan conditions. The chart does not display Year-5 cash flow under the "Interest-only over 5 years at 8%" conditions (i.e. -$227K) for convenience.

Scenario 2. Purchasing a commercial property

A firm purchases the property it currently operates in through a distinct entity.

Purchasing price	$400,000
LVR	100% (**secured**)
Type of loan	P&I
Term	15 years
Interest rate	5.5%

> Assumptions for the simulation: The loan is compounded yearly - instead of monthly - for simplification purposes.

The owning entity would make a profit from this asset, but it would still default on the debt. Indeed, the profit after tax would never be sufficient to cover the principal repayment under these conditions (see Appendix 2 for calculation details).

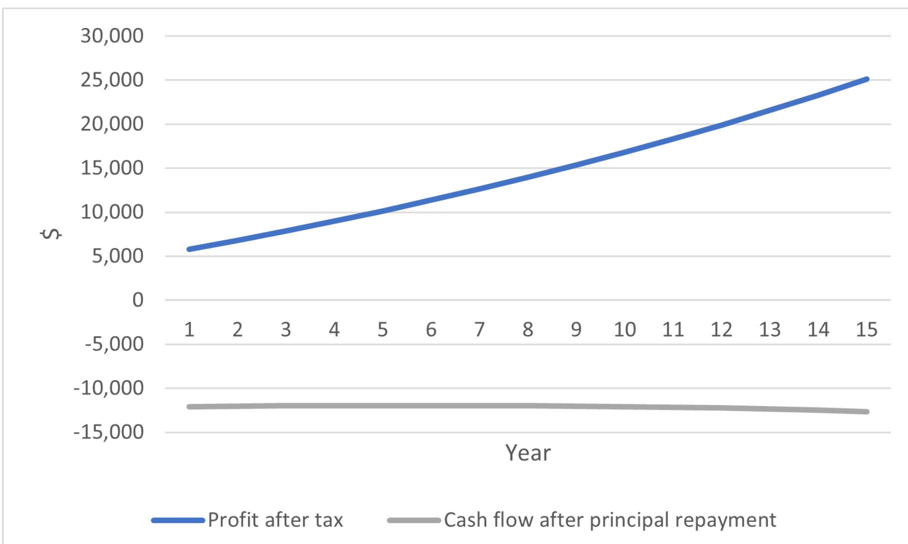

Figure 7: Projected profit after tax and cash flows.

Furthermore, the cash flow analysis below reveals that the property owner would fail to meet its obligations, whatever the interest rate, if the term remains at 15 years.

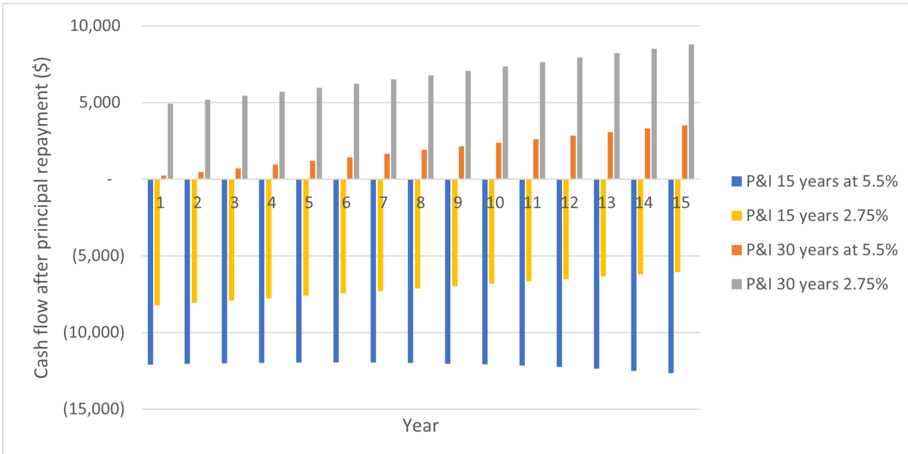

Figure 8: Cash flow after principal repayment under different loan conditions.

At the 5.5% interest rate, the entity would require a 30-year loan to have just enough cash flow available for principal repayment. Nevertheless, any unplanned expense would not be possible.

In contrast, if the lending conditions were the same as a residential mortgage, the property owner could honour its payments even under unexpected circumstances. Banks mainly justify this difference in lending conditions by the capital adequacy ratio (CAR) policy.

Capital Adequacy Ratio

The **capital adequacy ratio** is the ratio that banks must maintain between their capital and their assets (e.g., loans). In December 2019, the Reserve Bank of New Zealand (RBNZ) raised the CAR from 10.5% to 18% for the leading NZ banks (i.e., ANZ, ASB, BNZ, and Westpac) and 16% for the smaller ones (e.g., Kiwibank) (CNBC, 2019)(Vaughan, 2019). It means that banks must now hold between 16% and 18% of their loans in capital, making this CAR one of the strongest in the world (Index Mundi, 2019).

It is interesting to note that not all assets have the same weight in this ratio. Indeed, banks can discount assets depending on their **perceived risk**. Typically, in New Zealand, residential mortgage loans are considered safer than business loans. The following figure illustrates how a bank can maintain the same ratio by increasing the number of residential mortgages and reducing its exposure to business loans.

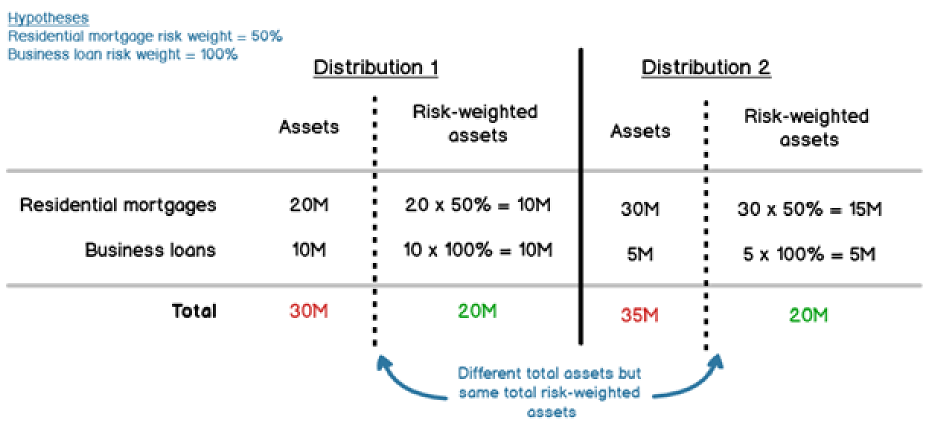

Figure 9: Examples of asset distributions yielding the same capital adequacy ratio.

The capital adequacy ratio policy thus incentivizes banks to favour residential mortgages at the expense of business loans.

Discussion

Knowledge Gap

A critical factor underlying SME debt vulnerability in New Zealand is the widespread misunderstanding of the **distinction between profit and cash flow**. Many small firms evaluate financial performance primarily through profit margins rather than liquidity indicators, leading them to overestimate their repayment capacity. Without an accurate proxy for available cash flow, businesses frequently contract loans that exceed their short-term payment ability, heightening the probability of default.

This informational asymmetry extends to financial institutions as well. Banks often rely on incomplete or backward-looking data when assessing SMEs' creditworthiness, failing to verify the quality and sustainability of cash flows prior to loan approval. Consequently, risk is mispriced, and when defaults occur, the institutional response is to tighten lending criteria across the sector. This creates a self-reinforcing cycle: limited financial literacy among SMEs and cautious risk assessment by banks mutually reinforce credit constraints, perpetuating the very instability the system seeks to avoid.

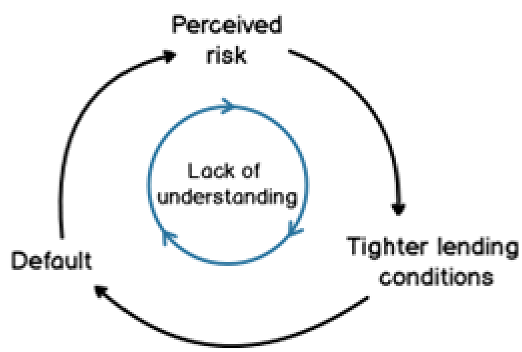

Figure 10: Loan to businesses risk cycle.

Loan Term

The **duration of bank loans** represents one of the most significant barriers preventing SMEs from effectively accessing and utilizing debt financing. Short loan maturities impose high repayment pressure, as principal instalments must be covered within limited timeframes. This obligation restricts firms' ability to invest in fixed assets or expand operations, both of which require stable access to working capital. Although temporary relief can be obtained through interest-only arrangements, such measures merely defer the problem: they increase the overall cost of borrowing and prolong exposure to financial risk.

The inability to secure long-term credit undermines SMEs' capacity to leverage debt as a strategic instrument for growth. For larger corporations, long-term bonds provide a mechanism to optimize capital structure and sustain investment cycles. In contrast, smaller firms lack both the scale and administrative capacity to issue bonds, leaving them dependent on banks as their sole source of external financing. This dependency reinforces structural asymmetry within the financial system, effectively placing SMEs in a captive relationship with lenders and constraining their potential to use debt as a tool for competitiveness and productivity.

Bank Policies

Current banking policies in New Zealand reveal a **structural bias** toward responding to regulatory and policy incentives rather than conducting granular, risk-based assessments of individual loans. This orientation distorts the allocation of credit between sectors, often disadvantaging small and medium-sized enterprises. Business owners who secure commercial loans with personal residential property remain subject to higher interest rates and shorter terms than standard mortgage borrowers, despite presenting comparable or even lower levels of credit risk.

Such discrepancies reflect a deeper misalignment in banks' capital allocation strategies. Commercial property lending is highly sensitive to increases in borrowing costs because its cost of equity remains relatively low, amplifying the effect of rate hikes on profitability and repayment capacity. This asymmetry not only discourages productive business investment but also fuels resentment toward perceived inequities in lending practices.

Moreover, these policies inadvertently reinforce the housing market bubble by channelling credit toward residential mortgages, which are treated as safer assets under existing prudential frameworks. While this approach minimizes short-term default risk, it amplifies systemic exposure: if housing prices were to correct sharply, banks could face a simultaneous decline in collateral value and a rise in defaults.

Investment Opportunities

Restrictive lending conditions not only constrain domestic business growth but also create unequal investment opportunities between New Zealand firms and foreign investors. Professional investors typically base their decisions on an expected return on equity (ROE) commensurate with perceived risk. When loan-to-value ratios (LVRs) are set excessively low, businesses must provide a larger equity contribution to secure financing, which in turn depresses their potential ROE. This misalignment between risk and reward discourages local investors from pursuing otherwise viable ventures.

In contrast, foreign investors, often benefiting from broader access to debt markets or more favourable financing conditions abroad, are not subject to the same structural constraints. Their ability to employ higher leverage grants them a competitive advantage, enabling them to acquire or expand assets at a lower cost of capital. This imbalance risks crowding out domestic enterprise, with strategic sectors increasingly influenced or controlled by international capital. Over time, such disparities could undermine local ownership, innovation, and economic resilience, highlighting the need for a more balanced and inclusive financial ecosystem for Kiwi businesses.

Recommendations

Adjusting the Risk Assessment

The RBNZ could reassess the risk weight of different asset classes, considering the housing bubble, to reduce the gap between residential mortgages and business loans.

Expected effects

- Limiting the incentive to invest heavily in residential mortgages
- Balancing the banks' asset distribution
- Reducing the perceived risk associated with loans to businesses
- Easing the businesses' lending conditions

Encouraging Banks to Reinforce Verifications

Banks should intensify controls to ensure that companies will be able to repay their debts.

Expected effects

- Preventing default from businesses
- Reducing the actual risk associated with loans to businesses

Raising Awareness Towards Debt Repayment

The government should launch a campaign to educate SMEs on the difference between profit and cash flows, as well as its implications for debt repayment.

Expected effects

- Improving the overall knowledge about financing activities
- Preventing default from businesses
- Reducing the actual risk associated with loans to businesses

Conclusion

New Zealand's SMEs face persistent structural barriers in accessing affordable debt, limiting their capacity to invest, innovate, and grow. Short loan terms, rigid collateral requirements, and banks' preference for residential lending constrain business development and reinforce systemic imbalance. A limited understanding of cash flow among SMEs further heightens default risk, prompting even stricter credit conditions and perpetuating a cycle of financial exclusion.

These dynamics not only weaken domestic enterprise but also give foreign investors an unfair advantage in acquiring Kiwi assets. Addressing this imbalance requires aligning bank and regulatory incentives with real credit risk while enhancing SMEs' financial capability. More equitable access to long-term financing would strengthen entrepreneurship, productivity, and the broader resilience of New Zealand's economy.

Appendices

Appendix 1. Calculation Details - Buying a Business

Scenario's lending conditions

Purchase price	$375,000
Bank loan conditions	
LVR	80%
Debt	$300,000
Term (months)	60
Interest rate (p.a.)	8.00%
Monthly interest rate	0.667%
Monthly P&I payment	6,083
Annual P&I payment	72,995

Loan's payment schedule

Year	**1**	**2**	**3**	**4**	**5**
Interest	22,163	17,944	13,375	8,426	3,067
Principal repayment	50,832	55,051	59,620	64,569	69,928

Calculations are made on a monthly payment basis, but this table displays annual figures for convenience.

Cash flow analysis

Year	1	2	3	4	5
Revenues	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
COGS	600,000	600,000	600,000	600,000	600,000
Gros profit	**400,000**	**400,000**	**400,000**	**400,000**	**400,000**
Expenses	200,000	200,000	200,000	200,000	200,000
EBITDA	**200,000**	**200,000**	**200,000**	**200,000**	**200,000**
Depreciation	40,000	40,000	40,000	40,000	40,000
Interest	22,163	17,944	13,375	8,426	3,067
Profit before tax	**137,837**	**142,056**	**146,625**	**151,574**	**156,933**
Tax	38,594	39,776	41,055	42,441	43,941
Profit after tax	**99,243**	**102,280**	**105,570**	**109,133**	**112,992**
Subtract Investment in working capital	25,000	-	-	-	-
Add back Depreciation	40,000	40,000	40,000	40,000	40,000
Subtract Investment in fixed assets	75,000	75,000	75,000	75,000	75,000
Available cash flow for repayment	**39,243**	**67,280**	**70,570**	**74,133**	**77,992**
Principal repayment	50,832	55,051	59,620	64,569	69,928
Cash flow after principal payment	**-11,589**	**12,229**	**10,950**	**9,564**	**8,064**

Appendix 2. Calculation Details - Purchasing a Commercial Property

Scenario's lending conditions

Rent	30,000
Purchase value	400,000
Bank loan conditions	
LVR	100%
Debt	400,000
Term (years)	15
Annual interest rate	5.5%
Annual P&I payment	39,850

For simplification purposes, payments occur yearly.

Loan's payment schedule

Year	Interest	Principal repayment
1	22,000	17,850
2	21,018	18,832
3	19,982	19,868
4	18,890	20,960
5	17,737	22,113
6	16,521	23,330
7	15,238	24,613
8	13,884	25,966
9	12,456	27,395
10	10,949	28,901
11	9,359	30,491
12	7,682	32,168
13	5,913	33,937
14	4,047	35,804
15	2,078	37,773

Cash flow analysis

Year	**Net rent**	**Interest**	**Profit from rent**	**Tax on profit**	**Profit after tax**	**Cash flow after principal repayment**
1	30,000	22,000	**8,000**	2,240	**5,760**	**-12,090**
2	30,450	21,018	**9,432**	2,641	**6,791**	**-12,041**
3	30,907	19,982	**10,924**	3,059	**7,865**	**-12,002**
4	31,370	18,890	**12,481**	3,495	**8,986**	**-11,974**
5	31,841	17,737	**14,104**	3,949	**10,155**	**-11,958**
6	32,319	16,521	**15,798**	4,423	**11,374**	**-11,955**
7	32,803	15,238	**17,566**	4,918	**12,647**	**-11,965**
8	33,295	13,884	**19,411**	5,435	**13,976**	**-11,990**
9	33,795	12,456	**21,339**	5,975	**15,364**	**-12,030**
10	34,302	10,949	**23,353**	6,539	**16,814**	**-12,087**
11	34,816	9,359	**25,457**	7,128	**18,329**	**-12,162**
12	35,338	7,682	**27,656**	7,744	**19,912**	**-12,255**
13	35,869	5,913	**29,955**	8,387	**21,568**	**-12,369**
14	36,407	4,047	**32,360**	9,061	**23,299**	**-12,504**
15	36,953	2,078	**34,875**	9,765	**25,110**	**-12,663**

Rents increase each year by 1.5%.

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