QON: Page 73

CHAIR: I just want to come back to this question about small business that Mr Kelly has raised on a number of occasions and this issue about the spread. The Reserve Bank data says that the spread has increased significantly in recent years relative to the cash rate. I think what your answer, and the answer of some of your peers, is is that you have been required to hold more capital against small business loans, which has increased the cost, and, in addition, there has been some other market related change. Is that right? Is that a fair summary?

Mr Hartzer: There are several components. Like the discussion we have had about mortgages, we do not fund small business lending at the cash rate. Our funding for small business loans reflects the term of those loans—the repricing frequency of those loans.

CHAIR: Yes, but the change relative to the cash rate with small business loans is much bigger.

Mr Hartzer: There are several elements in the change, and they have different repricing characteristics to mortgages. The first theme is that the costs of our funding relative to the cash rate have risen substantially in the last few years because it includes deposit costs as well. That is theme one. Theme two is—

CHAIR: Which applies, presumably, equally to mortgages?

Mr Hartzer: It applies in the same concept, but the amounts may be different because the funding characteristics and repricing characteristics of the small business lending portfolio are different than a mortgage portfolio. It is quite technical. We have a process we call 'funds transfer pricing' that tries to remove the interest rate risk from different products, so the funding cost assumption on different loans is different depending on the characteristics of that pool of loans. I do not want to get too technical but the amounts of the impact can be different, but the concept is the same. Then on top of that you have the higher equity cost, which reflects the fact that when the economy gets in trouble the level of losses in small businesses can be much higher, and that reflects on the amount of capital that we are required to hold.

CHAIR: And that was changed at some point?

Mr Hartzer: That has changed—correct. Peter, in a minute perhaps you could comment on the details of that. The third theme is the expected level of credit losses over a cycle, and it would be fair to say that in the past we probably underestimated what those losses would be. Now, as time has moved on, we have a better idea of that, and what the data clearly shows us is that small business loans go bad about five times more often than a home loan does. The loss rate, given that likelihood of going wrong, is about 10 times what we lose on a mortgage and when you are in a stress situation, which is what affects capital, that loss rate can go much, much higher, so the combination of all those things has fed into that difference. I would note, however, having said all of that, that the average rate on a small business loan is about one per cent—actually, a little less than one per cent—more than a home loan rate, so I would argue that that is not a massive premium—

CHAIR: Or residentially secured small business loans?

Mr Hartzer: Correct. We are talking about one per cent more, so there are all these factors. It is not a massive increase relative to a more—

CHAIR: The Reserve Bank data, and I do not have it in front of me, seemed to show a significantly larger increase in the spread between a cash rate and the small business rate than would be implied by the average rate being only one per cent more than for mortgages.

Mr Hartzer: Again, we can come back to you with the details on notice, the data that I saw in preparing for today said that the average rate that our customers pay on a small business loan relative to a residentially secured home loan is about one per cent.

Answer: Information available on the Westpac website shows current advertised rates for both mortgages and residentially secured small business loans, for example:

The advertised rate for Westpac's Rocket Repay (investor) home loan is 5.56%. From this rate, package discounting is subtracted. For mortgages greater than $750,000 this discount is 0.90% taking the customer rate to 4.66%.

The advertised rate on residentially secured small business variable rate loans is 5.24%.

	Rocket Repay Investor Home Loan > $750,000	Westpac Small Business Loan (residentially secured)	Difference
Advertised rate	5.56%	5.24%	
Package discount	0.90%	-	
Effective customer rate	4.66%	5.24%	0.58%

The higher pricing for business loans can be explained by the different risk profile of the products.