Commonwealth Bank
Commonwealth Bank of Australia
ACN 123 123 124

GPO Box 2719
Sydney NSW 1155

Telephone (02) 9118 7633

Matt Comyn
Executive General Manager
Local Business Banking

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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir

Access for Small and Medium Business to Finance

The Commonwealth Bank of Australia ("CBA" or "the Bank") presents the attached submission to assist the Committee in its deliberations. The submission provides an update to submissions the Bank has made in the past year to the Senate Economics Committee Inquiries into Access of Small Business to Finance (CBA submission lodged March 2010) and Competition within the Australian Banking Sector (CBA submission lodged December 2010).

1. About CBA's services for Small and Medium Business

CBA is Australia's largest financial institution on most measures. The Bank serves over 11 million Australian customers, employs over 45,000 people, operates the most branches (over 1,000) and ATMs (3,400) of the major banks, has assets in excess of over $600 billion on its balance sheet and manages or administers over $200 billion in additional funds for investors as part of our wealth management operations.[1]

Business banking is one of CBA's five key strategic priorities and it is the only priority that is specific to a line of business.[2] The Bank is strongly committed to being Australia's best business bank through excelling in customer service.

There are many definitions of small and medium sized businesses in use. For this submission we have used the definition consistent with Australian Prudential Regulation Authority (APRA) monthly reporting requirements, that is, client loan balances less than $2 million. This has a good overlap with small and medium businesses, and accounts for approximately 60 per cent of the Bank's total commercial lending portfolio.

[1] Refer to introduction of CBA submission to Senate Economics Committee Inquiry into Competition within the Australian Banking Sector for further information

[2] The other strategic priorities are: Customer service; Technology and operational excellence; Trust and team spirit; and Profitable growth. Further information about each of these strategies can be found at http://www.commbank.com.au/about-us/

The Commonwealth Bank:

- serves over 130,000 small and medium sized business customers[3];
- had over $26.7 billion outstanding in loans and asset finance facilities to these customers as at 31 December 2010, of which $7 billion was new funding issued during 2010[4];
- has over 60 business banking centres across Australia dedicated exclusively to serving these customers;
- has dedicated Business Bankers in over 80 per cent of CBA's branch network of over 1,000 branches;
- provides businesses with 24 hour/7 day access to business bankers through a market leading telephony platform; and
- is investing heavily in technology to continually improve customer service (eg CommBiz and NetBank online banking channels and our Core Banking Modernisation Program).

Since 2006, CBA has achieved a fast growth rate in business customer satisfaction. CBA has ranked equal first position in business customer satisfaction for the sixth month of the last seven months of this financial year among the major banks.[5]

Further evidence of our deep commitment to the small and medium business sector is our response to the recent disastrous floods. CBA announced flood assistance initiatives totaling $65 million covering both personal and business customers. We have set aside a further $1 billion in loan assistance specifically for business and agricultural customers who have been adversely impacted by these tragic events. Our support includes providing interest-free overdrafts up to $100,000 for three months for new or increases facilities to assist customers affected by the floods or Cyclone Yasi, as well as fee waivers on new commercial lending and cash rebates for asset finance needs.

2. There are many sources of finance for small and medium sized businesses

Small and medium sized business customers have a number of sources of financing available to them. CBA offers a full range of financing, working capital, transactional and merchant solutions to small and medium sized business customers.

There are numerous providers of business finance. All of the major banks and regional banks offer services, and a number of foreign banks also offer services. Credit unions and building societies also offer some business banking services.

[3] Including Bankwest
[4] This includes business loans and asset finance facilities
[5] According to DBM Business Financial Services Monitor, July 2010-January 2011. CBA continues to share equal first position with Westpac and ANZ (with NAB remaining last). However, CBA is the only bank to be ranked Number 1 in all segments; Micro (less than $1m), Small ($1m up to $5m), Medium ($5m up to $50m) and Large (more than $50m)

CBA provides finance to small and medium sized businesses in both metropolitan and regional areas of Australia. Some other lenders choose to focus more specifically on regional areas. CBA's regional clients are generally managed by our specialist agri-business division to ensure they receive the services and products best suited to their needs.

A further important dimension of competition comes from the presence of brokers. Brokers distribute 3.4 per cent of new commercial loans and 34 per cent of asset finance loans in the small and medium sized business market, covering both metropolitan and regional markets, and their share has been steadily growing. Their service proposition to customers is that they offer independent advice as to which loan or package of finance facilities will best fulfil the customer's needs across a range of finance providers. Brokers therefore add further competitive pressure to the banks, directly benefiting customers.

The Global Financial Crisis (GFC) had a fundamental impact on the cost of funding, which affected the supply of credit to, and the demand for credit from, business customers. The impact on the cost of funding is discussed extensively in CBA's submission to the Senate Economics Committee Inquiry into Competition within the Australian Banking Sector. The impact on demand was that small and medium sized business credit outstanding was relatively flat during 2008 and 2009. The weak demand reflects a combination of various factors, not least of all weak overall economic conditions and cautious management by businesses in response to those conditions. More recently, for the year to 30 September 2010, total system lending to businesses with loans of $2 million or less declined by 0.2 per cent whereas CBA increased its lending by 4.5 per cent. This reflects our commitment to and focus on this sector.

3. Price competition in business lending is strong

3.1 CBA's pricing is very competitive

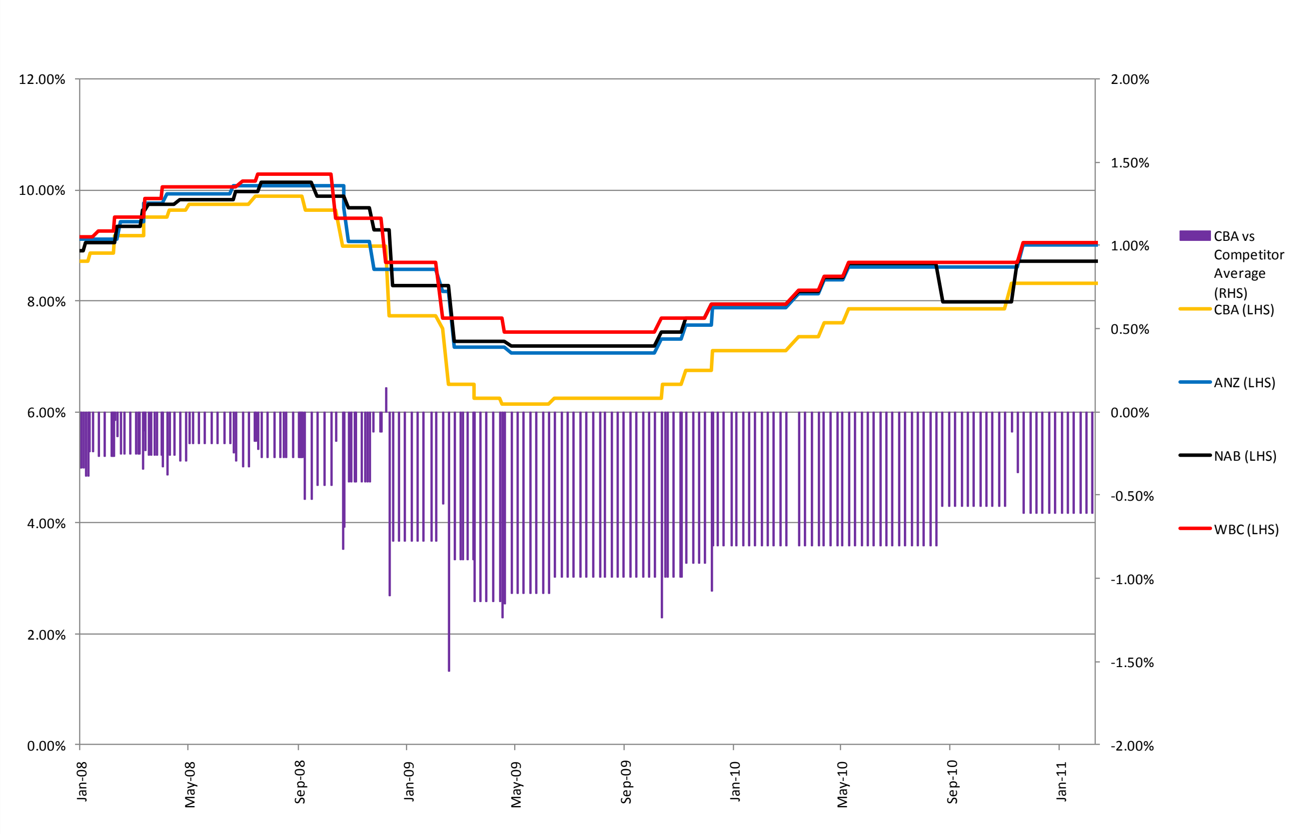
The strength of the Bank's lending to small and medium businesses and commitment to this sector can be demonstrated by the Bank reducing small and medium business interest rates more than any other major bank since the onset of the GFC.

The Bank's residentially secured business loan reference rate – the product that is most comparable to the retail home lending product – is currently at 8.31 per cent.[6] This reference rate has been the most competitive rate among the big four banks for over two years until recently[7], with the Bank actively advertising this rate in national and metropolitan newspapers. CBA's residentially secured business lending rate is currently 0.74 percentage points below the average comparable rate of the other major banks (Figure 1). Since the RBA's cash rate peaked in 2008, and taking into account recent increases, CBA has reduced its residentially secured business reference rate by a net 1.58 percentage points.

[6] As at 21 February 2011

[7] CBA estimate based on a comparison of the following products: CBA Better Business loan – residentially secured; ANZ Mortgage Index Rate until 21 October 2008 then Saver Index Rate which became ANZ's lowest residentially secured rate offered around this time; NAB Business Options Residential Rate until 29 August 2010 which was then closed for new business and replaced with Business Options Prime (Base Rate plus Liquidity Premium); Westpac Business Development Rate

Figure 1: CBA's residentially secured business lending rate is extremely competitive



Sources: The following product rates have been used as the most comparable historical comparison across major banks. CBA: Better Business loan – residentially secured; ANZ: Mortgage Index Rate until 21 October 2008 then Saver Index Rate; NAB: Business Options Residential Rate until 29 August 2010 which was then closed for new business and replaced with Business Options Prime (Base Rate plus Liquidity Premium); Westpac: Business Development Rate

Small business customers have benefited from the Bank's interest rate decisions as we have limited price increases as much as possible. This is despite the Bank facing continual pressure on its cost of funds since the credit crisis commenced (as has been extensively detailed in our submission to the Senate Inquiry into Competition within the Australian Banking Sector).

In the case of commercially-secured small business lending, CBA believes our decision in November 2010 to increase reference rates for commercially secured term loans by 25 basis points and not an additional amount despite generally higher funding costs, underlines the Group's commitment to the business sector. The other major banks increased their equivalent rates by an average of 39 basis points.[8]

[8] It is more difficult to compare pricing amongst the major banks for commercially-secured business lending because all customers are individually risk-rated and approximately 95 per cent are priced at a margin above or below the published reference rate. The reference rate in isolation is therefore not a very meaningful basis for comparing competitive pricing for commercially-secured loans. It is relevant, however, to compare the relative changes to reference rates because all loans linked to that rate will experience the same change in their pricing

3.2 The use of price-based advertising is a sign of a competitive market

A view has been expressed that price competition is weak in the small business sector. CBA does not believe this to be the case and points to some of the Bank's advertising campaigns since the GFC which have been very specifically price-based. This kind of price-led above-the-line advertising is not typical of an industry with weak competition.

3.3 Despite repricing for risk CBA's margins remain well below earlier levels

Competitive forces in the industry have systematically eroded risk premiums and returns on capital. The Bank's margins for commercial lending have shown a long-term declining trend, with a 23 per cent reduction in margins from the peak in 2002 to 2007. One of the key outcomes of the GFC was to highlight the true costs and risks inherent in lending, which has driven up the cost of liquidity and capital.

Since 2007, commercial lending margins have increased by 11 per cent as the Bank has priced risk more appropriately. Despite this increase, margins remain well below the levels of the early 2000s as competition remains strong.

3.4 CBA's lending standards have remained broadly unchanged in recent years

Importantly, the Bank has not made any material changes to its lending policies for small businesses since the financial crisis commenced. Our business lending approval rates have not changed before, during or after the financial crisis. This is despite other competitors exiting or scaling back their lending to the small business market during some of this period.

3.5 There are important differences between business lending and mortgages which result in different prudential requirements and lending rates

A view is sometimes expressed that because small businesses use their principal residence as security for their business loan, the interest rate should be the same as if the loan were a retail mortgage. There are, however, important differences between business loans, even if they are residentially secured, and mortgages.

Small business loans have both a higher probability of default and a higher loss given default. Banks are required by APRA to hold a higher amount of capital against business loans to absorb the higher expected losses, and this is costly. Importantly, this has not impeded our appetite for business lending as evidenced by our growing business loan book.

Banks also incur greater costs in originating and monitoring business loans because of the greater complexity of business lending, the greater risk and the greater individual tailoring of loans that is required.

These costs must be recouped in loan pricing and is done via a higher risk margin, over and above the mortgage rate. At CBA, the residentially secured business rate is 50 basis points above the standard variable home loan rate (SVR). Taking into consideration average discounts to the SVR, CBA's differential between business and retail rates is 70 basis points lower than the average differential of the other major banks as reported in the RBA's submission. Further details on the sources of this difference between SVR and SME loan pricing are outlined below:

- *Small business loans have a higher probability of default:* The financing need of most small business customers and the income with which they service their loans is typically more variable and less easily verified, than is the financing need of most home loan customers and the capacity they have to service their mortgage. This translates into a consistently higher probability of default for a business loan than a retail loan, and consequently pricing of loan facilities used for business purposes needs to cater for this greater risk.

- *Small businesses have a higher loss given default:* The loss a financier incurs on a small business loan in the event that the loan does default is also higher than the loss a financier will incur on a personal mortgage. This is partly because a wider range of security options (eg farms, commercial property, equipment, etc) are accepted, and because these security options are less liquid they are less likely to recoup full value in a wind-up situation. Furthermore, sometimes business loans are unsecured. The higher loss given default is also because legal costs are, on average, higher in the event of foreclosure on a business loan and the process is more protracted than on a mortgage, even if the business loan is residentially secured.

- *Higher capital provisioning:* Because of the greater risk attached to business lending, APRA requires banks to hold a greater amount of capital for business lending than for mortgage lending. The capital serves as a buffer for banks to be able to absorb losses on loans and remain open for business, but incurs a cost which has to be priced in business loans.

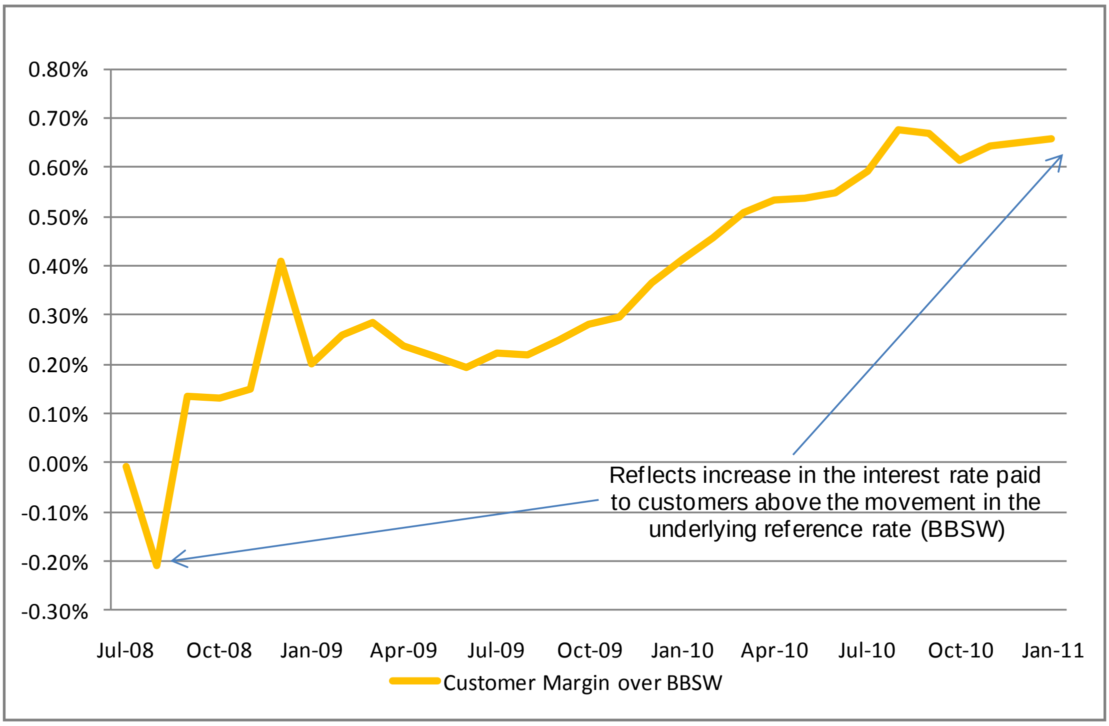
- *Small business is serviced differently by banks:* CBA and Bankwest choose to service business customers via specialist Business Bankers in branches as well as specialised Business Banking Centres. The complexity of business lending is much greater than for retail clients. We choose to offer more personalised attention to these clients with a tailored banking solution and this unavoidably comes at a higher cost.

4. Price competition for business deposits is also strong

On the deposit side (transaction banking, savings and term deposits), competition continues to be strong.

The margin paid to customers (that is, the difference between our funding costs and the deposit rate offered to our customers) on our business term deposit product (Cash Deposit Accounts) has grown significantly in the period from July 2008 to currently, as shown in Figure 2.

Figure 2: Margin paid to SME deposit customers



Source: CBA
Note: BBSW is Bank Bill Swap Rate

The competition for transaction accounts has been intense and delivered via increased functionality and bundling of prices across multiple products. The Bank has competed aggressively in this area, having run significant advertising campaigns since the GFC on small business deposits at a cost to the Bank of more than $3 million over the last 12 months.

5. Caution should be exercised in further regulating the sector

The provision of banking services to SMEs is subject to considerable regulation and oversight. Key regulations applying to the CBA Group include the Banking Act, the Corporations Act, prudential requirements and the recently enacted Competition and Consumer Law. We also are voluntary signatories to the Code of Banking Practice.

CBA does not have any major concerns with the current regulatory or oversight framework. The evidence of its success is that Australia’s banking system has proved resilient under the very severe stress test of the GFC. It is through the combination of a sound regulatory and prudential framework, the Government’s support for the financial system during the GFC, timely unwinding of that support, and sound management that Australia’s banks have withstood the worst effects of the GFC.

Notwithstanding this resilience CBA accepts the scope to further improve the framework and the global agreements to do so (such as the implementation of Basel III). These agreements will have a significant impact on the Australian banking system over several years to come. Caution should be exercised in recommending additional regulatory changes.

CBA also has an internal dispute resolution arrangement available to our customers. This is a condition of being a signatory to the Code of Banking Practice.

6. Other ways in which CBA supports small and medium sized businesses

The Bank launched a range of initiatives to further support small businesses in the midst of the financial crisis. These initiatives included the business 'health check', the Small Business Investment Package, asset financing stimulus and risk management solutions. Further information regarding the Bank's initiatives is contained in our submission to last year's Senate Inquiry into Access of Small Business to Finance.

We have also significantly invested in online and systems enhancements (CommBiz and NetBank online channels) and continue to invest in replacing our core banking platforms. These investments have enabled small businesses and other clients to take advantage of more cost effective and timely processing. It also empowers small business people to transact with the Bank outside core business hours, freeing up time to invest in their business. Further significant improvements will be delivered in the next couple of years.

The Bank has installed over 18,000 contactless payment readers across Australia almost exclusively in small to medium sized businesses. The readers have been installed free of charge by the Bank with all costs, of over $2 million, met by the Bank on behalf of the small and medium business sector. The benefits of contactless payments to the recipient businesses include faster transaction processing, reduced cash handling expenses and the reallocation of payment authorisation risk from the merchant to the card issuer.

CBA and BankWest regularly provide short term assistance to help small businesses overcome temporary cash flow hurdles in the normal course of business. Other arrangements may include repayment holidays and restructuring facilities. It is in both CBA's and the customer's best interests to resolve any financial difficulties as soon as possible and in a mutually agreeable manner.

As noted in section 1, CBA also announced flood assistance initiatives totaling $65 million covering both personal and business customers in response to the recent disastrous floods. We have set aside a further $1 billion in loan assistance specifically for business and agricultural customers who have been adversely impacted by these tragic events. Our support includes providing interest-free overdrafts up to $100,000 for three months for new or increased facilities to assist customers affected by the floods or Cyclone Yasi, as well as fee waivers on new commercial lending and cash rebates for asset finance needs.

CBA remains firmly committed to only engage in responsible lending to the small and medium sized business sector. It is our legal obligation and one which also best serves our shareholders' long-term interests.

Also noteworthy is the very low number of our customers in financial hardship that require the assistance of the Bank's specialist workout team. This is consistent with our historically lower loss impairment expenses than our major competitors.

7. Conclusion

Australia has been well served by our stable, well regulated and prudently managed banking sector, particularly during recent episodes of severe turbulence in global financial markets. The strength of the sector has ensured a continuous supply of credit to business and personal customers that has helped sustain the Australian economy during a period when many other economies have faltered. Australian banks and their regulators are regarded as world class and have successfully protected depositors and borrowers from the worst impacts of the GFC. The sector is fundamentally sound and competitive.

With specific regard to small and medium sized business finance CBA does not believe any major market failures exist. As noted above, the evidence includes:

- there are many providers of small and medium sized business finance across a wide range of products;
- CBA’s loan approval rates have remained high during and after the GFC;
- there are legitimate reasons why APRA requires additional capital be held for small and medium business lending, which carries a higher risk than mortgage lending;
- the GFC is the most recent reminder of why higher risk lending must be priced accordingly;
- CBA’s pricing of small and medium sized business lending has been very competitive for a sustained period of time — in fact, we have had the lowest or second lowest rate amongst the major banks for residentially secured business loans for over two years;
- CBA is investing large amounts in technology improvements which have delivered, and will continue to deliver, significant benefits to our business customers;
- CBA has, and will continue to, only engage in responsible lending to the business sector;
- CBA always stands ready to help its business customers work their way out of financial difficulties should these arise, in a mutually agreed manner; and
- CBA has worked hard to improve how satisfied its business customers feel with its service — in fact, CBA has scored equal highest amongst the major banks for much of the past year on customer satisfaction surveys.

There are major regulatory reforms yet to be implemented in Australia (especially Basel III) which will have a significant impact on the banking sector. Caution should be exercised in recommending further regulatory change.

If there is any further material that may be of assistance to the Inquiry please contact John McLenaghan, Head of Government & Industry Affairs, on (02) 9118 7686.

Yours sincerely

Matthew Comyn