Small Business

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1. Small business finance market

1.1.1 Context to competition in small business finance

Businesses have four main sources of financing, each offering different risk and return characteristics. First, businesses can issue equity in their business, either on a private basis or by listing stock on a publicly traded exchange.

Second, they can borrow directly from the public by issuing debt securities in their own name. Third, businesses can invest operating profits back into their business. And fourth, they can borrow from lenders such as banks.

For small businesses and medium (SME) sized businesses, often defined as those businesses with loans under $2 million, the latter two options (re-investing earnings and lending) are most applicable, as issuing debt or equity directly to the public is uneconomic and often impractical on a small scale.

A key issue in the small business finance market over many decades has been the ease of access small businesses have to bank loans and, to a much lesser degree, the interest rate payable on those loans.

The issue of small business access to bank finance appears to have emerged sometime in the 1960s. The 1965 Vernon Inquiry – a major investigation into Australia's economy – noted that it had received some representations from business that accessing bank finance was difficult.

After commissioning some expert opinion, the Vernon Committee concluded that the demand for finance by small business was being reasonably well satisfied, although it did recommend further investigation.

Against a backdrop of high and sustained inflation, in 1978 the Fraser Government commissioned a major inquiry into the financial system, known as the Campbell Inquiry. Access to finance by small business was investigated by the Committee. In its conclusions, the Inquiry found that any deficiency in the supply of small business finance was likely to be related to the restrictive regulatory environment.

Deregulation of the financial system in the mid-1980s liberated banks to compete more aggressively in the business finance market. This competition was spurred by the entry of 15 foreign banks in 1985. The period of 1985 to 1990 marked a considerable expansion in business and property lending, including SME finance.

This period of credit expansion spilt into property prices and this is one of the factors that helped create the conditions for a significant recession in the early 1990s. The losses on bank business and property lending were material and this lead to a re-evaluation of business and property lending risk. (While the losses in the 1990s recession were greatest to large business, small businesses losses were also significant.)

Banks introduced higher collateral requirements and, generally, a more rigorous process to source bank financing was applied, particularly for businesses that had a higher risk profile.

As a result, in the period from the early 1990s to mid-1990s, small businesses and their advocates voiced concerns over access to finance. Yet, the concerns seemed to dissipate over time. From the late 1990s till 2007, business surveys and other evidence indicate that small businesses generally had sufficient access to bank finance. Due to this high availability of funding and competition, margins were contracting on business lending by around 10 basis points per annum[1], and the risk premiums being charged reduced. Some lenders eased their credit standards and non-bank lenders made credit available to segments of the market that were not being served by banks due to their risk profile.

With the commencement of the GFC in mid-2007, the risk environment changed markedly and, as with all periods of economic uncertainty, such as the 1990s recession, the banks and non-bank lenders took steps to re-evaluate risks associated with business lending.

Overall, while some high risk business loan products were removed (e.g. low-doc business loans), banks did not materially change lending policies towards SMEs. The main stress[2] in the market came from the exit of non-bank lenders, suppliers that typically dealt with customers whose risk profile prevented them obtaining bank finance.

In 2009, business surveys showed significant concerns over access to bank finance (see Appendix 4). This concern was magnified because, as already stated, many businesses had become more reliant on bank finance as other sources of finance had become more problematic, such as automobile leasing finance from non-bank financiers.

A Senate inquiry on Small Business Finance reported in 2010 and concluded in relation to the supply of credit that:

"The slowdown in lending to small business appears to reflect a combination of demand factors…and supply factors such as;

- *fewer small businesses being able to meet existing lending standards in the wake of the global recession;*
- *some tightening of lending standards by financial intermediaries. It is arguable that banks were tending towards recklessness in the preceding boom, and that some tightening of credit standards represents a prudent return to 'normal' practice, but there may also be cases where banks are over-reacting; and*
- *non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive."*[3]

Within the categories of business lending, the data shows that lending to the small business sector was reasonably stable through the GFC whereas there were net declines in credit volumes to larger business.

1.1.2 State of competition today

Market size and growth rates

Total business lending, including credit to small, medium and large businesses, stands at $683 billion, equivalent to 34% of total credit in the economy.

Currently, the annual growth rate in overall business lending is -3.2%. Growth has fallen every month for the last three months. The average growth rate in business credit since the year 2000 is 8.4%. This current downturn reflects primarily reduced demand, driven by continued balance sheet deleveraging, concern over the economic outlook and higher interest rates resulting from monetary policy and bank risk repricing.

From a credit supply perspective, there is evidence of a more normal environment since the difficulties experienced in 2008 and 2009. The August 2010 ACCI business survey shows that the issue of access to bank finance does not register in the top 5 constraints to

[1] The ABA notes this estimate is based on discussions with a major bank.
[2] Another point of stress was in the commercial property lending market. Given historically this type of lending has caused problems for banks, it is a fact that banks took steps to reduce their overall exposure to this market.
[3] Senate Economics References Committee. Access of Small Business to Finance. June 2010.

investment in any of the business categories: small business, medium business or large business (see Appendix).

Growth in small business lending (that is defined as loans under $2 million) has held up better than the wider business lending market over the last 12 months. It is currently flat, although this category of lending has not experienced a material decline in absolute balances throughout the GFC. Commercial property lending is showing signs of picking up, having declined materially post GFC.

Through the course of 2010, many banks have undertaken extensive advertising campaigns aimed at the small business sector and a number of banks have announced significant expansions in the hiring of business bankers.

Products and providers

The Cannex website includes data[4] on small business lending, deposit and credit cards – see summary in Table 1. It shows:

- There are 26 providers of business transaction accounts, offering 33 products, with interest rates ranging from 0% to 6.15%.
- Fifteen providers of credit cards, offering 37 different products. Interest rates range from 10.98% to 20.4% with an average of 15.66%.
- Twenty four providers of business overdrafts offering 55 different products. Interest rates range from 6.5% to 15.64%.
- Twenty seven providers of residentially secured overdrafts. There are 55 products advertised with an interest rate range of 4.85% to 12.39%. The average rate is 8.43%.

Table 1 – Business banking: Selected products

Market	Provider choices	Product choice	Interest rate range (% annual)			
Business banking	Number	Number	Min	Max	Average	Mode
Business transaction accounts	26	33	0.01%	6.15%	0.45%	0.01%
Business Credit cards	15	37	10.98%	20.40%	15.66%	17.15%
Business overdraft	24	55	6.50%	15.64%	9.68%	10.05%
Residential secured overdraft	27	55	4.85%	12.39%	8.43%	7.33%

Source: Cannex

Pricing

While indicator reference[5] rates in the deposit market are well over long-term averages, interest rates paid by small business are also above long-term averages. Estimates of indicator business lending rates are published by the RBA. They show:

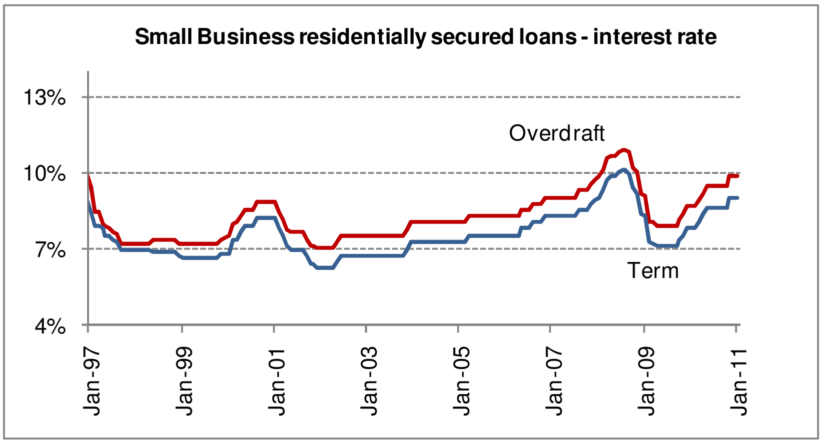
- Interest rates on residentially secured term loans are currently 9.0%, compared to an average since 2000 of 7.71%.
- For residentially secured overdrafts, the current rate is 9.85%. The long-term average is 8.48%.

[4] The ABA notes that data was sourced prior to the RBA November Board Meeting.
[5] The ABA notes that reference rates are only a guide as most banks will price each client based upon the client's risk profile. This can be done through either rating the likelihood that the borrower will default and/or an assessment of the underlying collateral.

- Unsecured small business term loans are currently 9.70%. The average since 2000 is 8.32%.
- Unsecured overdrafts are around 10.65%, whereas the long-term average is 9.17%.

Relative to housing rates, the current business rates appear to be elevated, indicating that banks have priced in more risk in business loans than housing loans. In times of uncertainty, business rates usually have higher risk premiums loaded in as these loans are riskier, even for residentially secured business loans.

Graph 1 – Small business loans – residentially secured



Source: RBA data

Margins

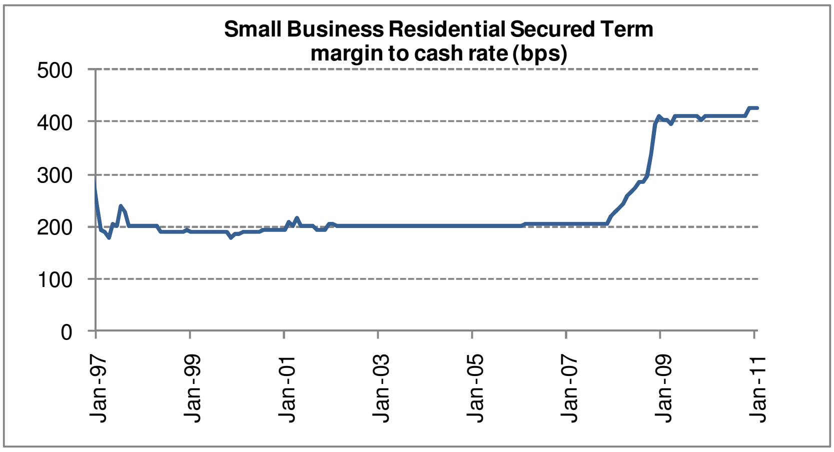
As with the margin between the housing standard variable loan rate and the cash rate, business loan margins have also increased since the global financial crisis in 2007.

For 10 years prior to the GFC, the margin between the cash rate and the small business residential term secured variable rate was very stable, averaging about 200 basis points (i.e. 198 bps). Since then, the increase in the small business margin has been more marked – increasing by around 200 basis points, whereas the housing margin increased only 110 basis points[6].

The reasons for this higher small business margin increase are three fold: (a) small business loans are riskier and so attract a higher risk-premium than residential housing loans; (b) the margins being charged before the GFC were too low and the higher margin today reflects a more appropriate rate, and (c) higher levels of capital are required for small business loans (compared to housing) as part of the prudential regulatory regime.

[6] The ABA notes that data was sourced prior to the RBA November Board Meeting.

Graph 2 – Small business lending spread



Source: RBA data / ABA calculations

Appendix 1: Small Business Survey

ACCI small business survey on investments constraints - 2005 to 2010, August Editions

Small Business		2005	2006	2007	2008	2009	2010
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Business Taxes and Government Charges	Insufficient Demand
	2	State Government Regulations	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Insufficient Demand	Business Taxes and Government Charges
	3	Availability of Suitably Qualified Employees	Local Competition	State Government Regulations	Level of Interest Rates	Charges by Lending Institutions	State Government Regulations
	4	Federal Government Regulations	Insufficient Retained Earnings	Wage Costs	Non-Wage Labour Costs	State Government Regulations	Federal Government Regulations
	5	Non-wage labour Costs	State Government Regulations	Charges by Lending Institutions	Wage Costs	Wage Costs	Insufficient Retained Earnings
Medium business							
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Business Taxes and Government Charges
	2	Availability of Suitably Qualified Employees	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Wage Costs	State Government Regulations	Local competition
	3	State Government Regulations	Wage Costs	Local Competition	Business Taxes and Government Charges	Raising Loans from Financial Institutions	Wage costs
	4	Non-wage labour Costs	Local Competition	Wage Costs	Non-Wage Labour Costs	Insufficient Demand	Non-Wage Labour Costs
	5	Wage Costs	State Government Regulations	State Government Regulations	State Government Regulations	Wage Costs	Insufficient Demand
Large business							
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Availability of Suitably Qualified employees	Raising Loans from Financial Institutions	Availability of Suitably Qualified employees
	2	Availability of Suitably Qualified Employees	Availability of Suitably Qualified employees	Insufficient Demand	Federal Government Regulations	Charges by Lending Institutions	Business Taxes and Government Charges
	3	State Government Regulations	Non-Wage Labour Costs	Wage Costs	Business Taxes and Government Charges	Raising Equity Capital	State Government Regulations
	4	Local Competition	State Government Regulations	Federal Government Regulations	State Government Regulations	Insufficient Demand	Federal Government Regulations
	5	Non-wage Labour Costs	Insufficient Demand	Local Competition	Local Competition	Business Taxes and Government Charges	Non-Wage Labour Costs

Appendix 2: Data Sheet – Small Business Lending

Please see attachment