AUSTRALIAN BANKERS' ASSOCIATION INC.

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31 March 2010

Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Committee Chair,

Inquiry into Access of Small Business to Finance

The Australian Bankers' Association is please to provide the attached submission to the Inquiry into Access of Small Business to Finance, and looks forward to appearing before the Committee to represent the banking industry's views

Yours sincerely

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Steven Münchenberg

Inquiry into Access of Small Business to Finance

31 March 2010

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Inquiry into Access of Small Business to Finance

1. Introduction

Small business is a crucial and very large market for Australian banks:

> *Small and medium-sized businesses play a vital role in the Australian economy. They represented around 2 million actively trading businesses in June 2007 and employed around 42% of total employed persons in Australia. They are estimated to have contributed around 46% of Australia's Gross Domestic Product (GDP) in 2006.*[1]

It is a highly contested market, with bank and non-bank providers striving to win business through product innovation, service differentiation and competitive pricing.

As with all sectors in Australia, small business has faced many challenges in recent times. Banks too have had to face the most serious financial crisis since the great depression, but have stood by their customers and provided finance to enable continuing operations, and have supported business growth and new investment activities.

Australian banks will continue to support viable small business customers with a very diverse product range, including lower cost product options, and advice on how to choose the best product for their needs. Banks have not been entirely immune from the global shocks to the financial system, but by maintaining strong risk management, including the risk management of credit decisions, they will be able to continue to underpin the operation of the economy as a whole.

ABA member banks have told us that there has been no decision to withhold or constrain the provision of credit to any customer segment. Each proposal from a small business is judged by the bank on its merits. Banks lend money after assessing that a customer has the capacity and willingness to repay, that they understand the risks they are taking and have the capacity to manage those risks. This is consistent with the need to preserve a sound banking system and a healthy small business sector.

Recent surveys of business conditions and business confidence[2] indicate that Australia's economic recovery is well established, and banks will continue to support their small business customers, who may now for example, be pursuing growth and expansion plans.

2. Key points

(1) Banks are still lending to viable businesses:

- As at the end of November 2009, the stock of lending to business by ABA member banks was $369.4 billion, an

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[1] http://www.abs.gov.au/ausstats/abs@.nsf/0/C43B334AB530F56DCA256DB100025E96

[2] See for example: http://www.acci.asn.au/text_files/surveys/Westpac_Survey/Issue194Mar10.pdf, and http://www.nab.com.au/wps/wcm/connect/d9237f8041b0ef2a97cfb7476d50eb20/MBSFeb10PR.pdf?MOD=AJPERES&CACHEID=d9237f8041b0ef2a97cfb7476d50eb20

increase of more than $30 billion from the beginning of the global financial crisis.

(2) Interest rates are still low:

- RBA data for December 2009 show that the weighted interest rate for business loan outstandings from banks, where the loan value is less than $2m, is 7.60%.
- While it has increased by 50 bps over the past quarter, there were three increases in the cash rate (totalling 75 bps) over that time. It is also 160 basis points lower than the most recent peak of 9.20% reached in September 2008.

(3) There is no fall-off in the supply of credit:

- ABA member banks are well capitalised and bank funding programs have recovered, including strong growth in deposits.

(4) There has been a reduction in the demand for credit:

- ABS data shows that the demand for new lending has been falling, although bank lending has not slowed to the same extent as for non-banks. The trend for banks appears to be demand- and not supply-driven.

(5) Banks must lend prudently and price for risk:

- capital required by APRA to be held by banks for SME business loans is generally three times higher than for home loans;

(6) The small business market is highly contested and offers a wide array of products.

(7) Banks support their customers with a wealth of information and specific business banking products and services.

3. Cost, terms and conditions of finance

3.1 Price of credit

In general, interest rates for most small business products have responded to the 75 bps of tightening by the Reserve Bank (RBA) since October 2009, moving by 70bps to 80bps over that period.

The interest rate on a residential secured loan saw a 300 bps fall during the RBA interest rate reductions from September 2008, reaching a low of 7.10% for a period of six months from April 2009 to September 2009. It is now at 7.85%, 12 bps higher than the three year average prior to the global financial crisis (7.73%).

Over the period of the easing cycle (September 2008 to February 2009), the RBA reduced the cash rate by 425 bps. Lending rates to small business responded by falling by up to 300 bps over that time.

February 2010		**CUMULATIVE change in basis points (bps) since:**				
Small business loans	**Current rate**	**last month**	**3 months**	**6 months**	**12 months**	**this cycle**
Cash rate	3.75%	0	25	75	50	75
Residential secured						
. Term	7.85%	0	30	75	55	75
. Overdraft	8.70%	0	35	80	60	80
Other						
. Term	8.60%	0	25	70	60	70
. Overdraft	9.55%	0	30	75	60	75
Small overdraft	10.10%	0	30	70	60	70
3 year fixed	8.30%	-10	-20	20	180	15

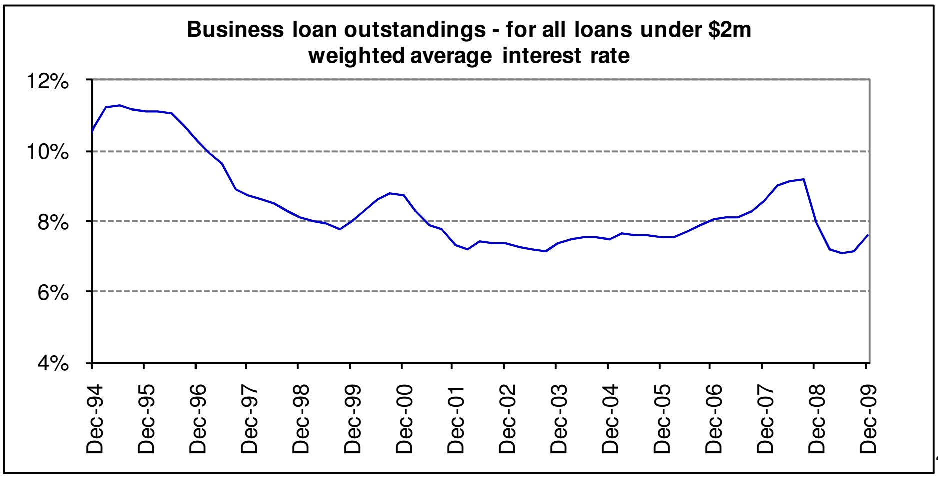
[3]

It is important to note that the cash rate is not an accurate indicator of a bank's cost of funds, and that only a proportion of bank lending to small business is linked to the cash rate.

RBA data for December 2009 show that the weighted interest rate for business loan outstandings from banks, where the loan value less than $2m, is 7.60%. While it has increased by 50 bps over the past quarter, there were three increases in the cash rate (totalling 75 bps) over that time. It is also 160 basis points lower than the most recent peak of 9.20% reached in September 2008.

The current weighted average rate of 7.60% remains 12 bps below the three year average prior to the global financial crisis (7.72%).

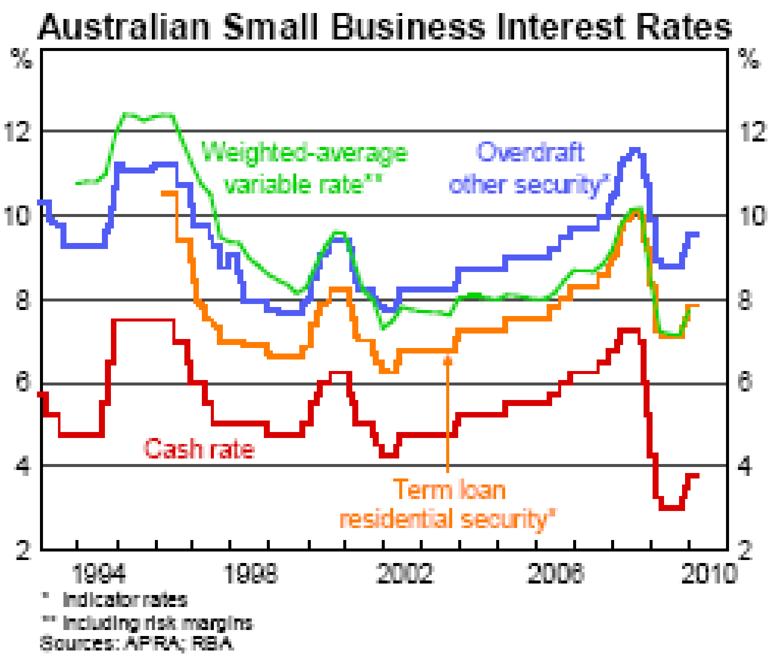
[3] Source: Reserve Bank. Note that is the most recent RBA data available, and does not include the 0.25% increase in the cash rate on 3 March 2010.



[4]

The Reserve Bank's explanation for interest rate movements over the last few years is:

> *"In setting interest rates on loans, banks take into account changes in their overall cost of funds. For a number of years prior to the global financial crisis, banks' overall cost of funds followed the cash rate reasonably closely as risk premia in markets were low and stable, and therefore banks tended to adjust their lending rates mainly in response to the cash rate. The relationship between the cash rate and the banks' indicator rates on variable housing and small business loans was particularly close from 1998 to 2007, though the average actual rates paid by housing and business borrowers declined a little relative to the cash rate during this period (Graph 8). Before then, however, banks' lending rates did not follow the cash rate particularly closely.*



[5]

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[4] Source: Reserve Bank

…As the global financial crisis unfolded, banks' lending rates have risen relative to the cash rate, reflecting their higher funding costs. The banks have raised their lending rates relative to the cash rate for all of their loan products. The sizes of the increases have varied considerably across the different loan types, however, reflecting factors such as changes in the banks' perceptions of the riskiness of the borrower, the speed at which loans can be repriced, and the sensitivity of the borrower to changes in lending rates.[6]

3.2 Bank fees

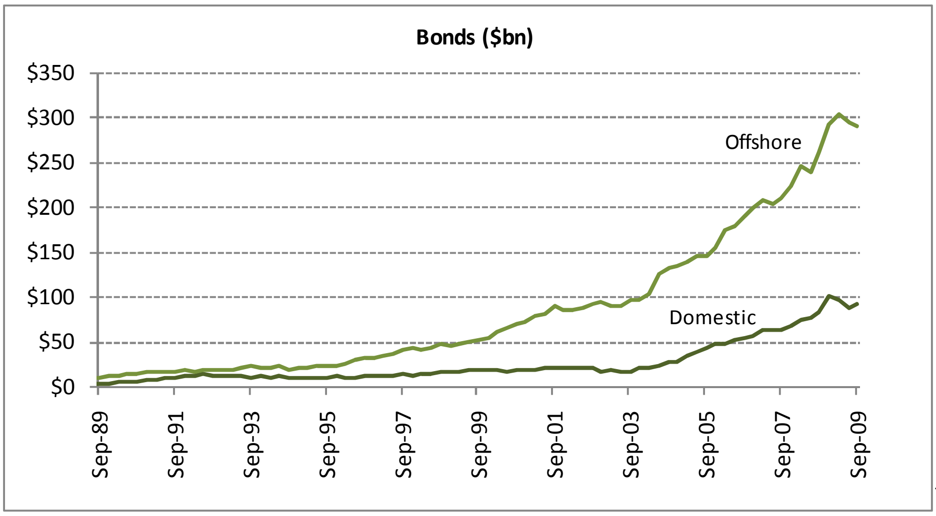
There have been significant downward movements in bank fees for small business and other customers over the last 12 to 18 months, and in some cases, an abolition of certain fees.

3.3 Bank funding

Since the credit crisis commenced, banks have faced continual pressure on their cost of funds.

The three sources of funding: deposits, short-term funding, and long-term funding have all contributed to this pressure, although short-term funding is starting to ease.

The composition of banks' long-term funds at the end of September 2009 was: bonds issued domestically $92.5 billion (24%), and bonds issued offshore $291.2 billion (76%).



[7]

Bank 3 year AA debt issuance is a good measure of banks' longer term funding costs. To see if the cost of banks' long-term funds has increased, we compare bank 3 year AA debt issuance with the 3 year Quarterly Aussie Dollar Swap Rate.

Prior to August 2007, banks paid only a small amount above the 3 year Quarterly Aussie Dollar Swap Rate for their longer term funds, about 12 basis points.

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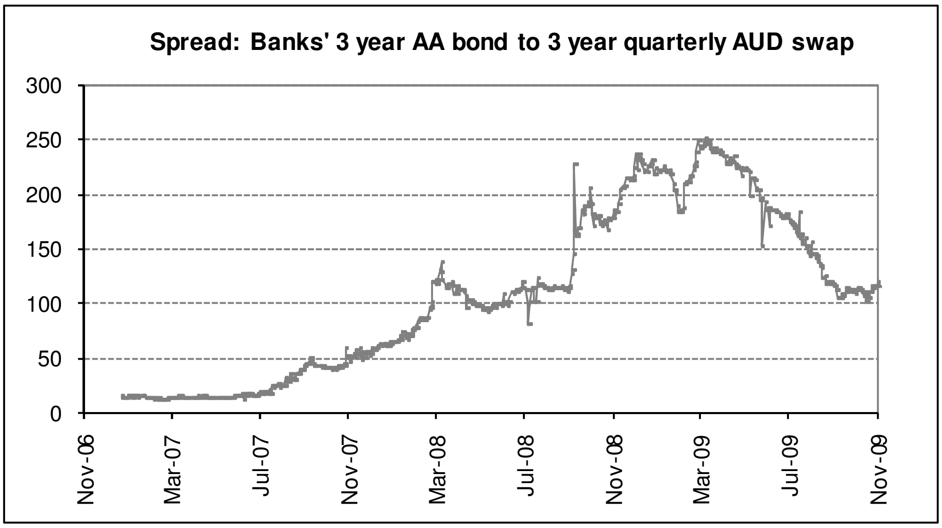
[5] http://www.rba.gov.au/chart-pack/interest-rates-australia.pdf
[6] http://www.rba.gov.au/publications/bulletin/2010/mar/6.html
[7] Source: ABS

After August 2007, the spread increased dramatically and has been volatile. As at 17 November 2009, the cost of banks long-term funds was 116 basis points above the 3 year Quarterly Aussie Dollar Swap Rate.



3.4 Volume of credit

Banks are continuing to make loans to viable small businesses and many are looking to grow their loan books.

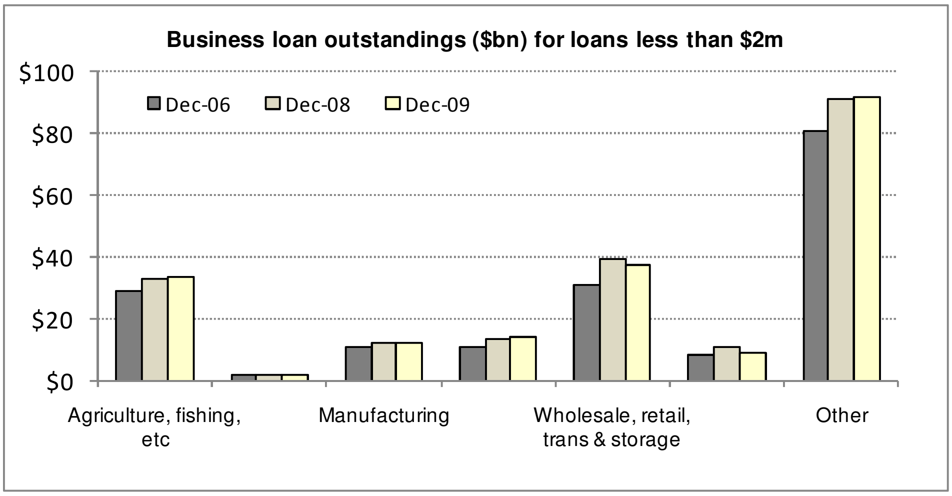
Over the past year, to the end of December 2009, business loan outstandings of $2 million or less fell across a range of industries but the overall fall was very small (1.1%), with the largest decrease being in finance and insurance, probably as result of reduced demand in the sector during the global financial crisis.

Loans outstanding	**Dec-06**	**Dec-08**	**Dec-09**	**Growth**	
(under $2 million)	**$bn**	**$bn**	**$bn**	**last year**	**Avg 3 yrs**
Agriculture, fishing, etc	$29.0	$33.0	$33.5	1.2%	5.2%
Mining	$1.7	$2.2	$2.2	-0.7%	9.8%
Manufacturing	$11.2	$12.3	$12.1	-1.5%	2.8%
Construction	$11.4	$13.6	$14.1	3.4%	8.0%
Wholesale, retail, trans & storage	$31.2	$39.4	$37.5	-4.6%	6.7%
Finance & insurance	$8.2	$11.2	$9.4	-16.0%	4.9%
Other	$80.6	$91.0	$91.8	0.8%	4.6%
Total	$173.2	$202.7	$200.5	-1.1%	5.3%

[8]

(A graph of the above data follows.)

[8] Source: APRA



3.5 Prudent lending

The needs that face businesses will depend upon the nature and type of the business, what it is trying to achieve at any time, and the stage of the business life cycle. The nature of business lending is typically more complex than consumer lending – and requires tailored solutions.

Circumstances can change very quickly, and the needs of the business can also change very quickly. For example, non-payment or delayed payment of a major invoice may suddenly have a major impact on cash flow. Depending upon the circumstances, losses to the business (and creditors' exposure) can build rapidly.

Banks must lend prudently and must price for risk. They must do this to comply with prudential regulation as well as meeting commercial objectives for their shareholders. Capital required by the Australian Prudential Regulation Authority (APRA) to be held by banks for small business loans is generally three times higher than for home loans, and can be seven times higher for some products.

Loans are priced to cover the cost of funds as well as the risk taken on by the lender. The risk relates to how likely a customer is unable to repay the loan (their probability of default) and what could potentially be recovered if that was to occur (the potential loss given default).

For example, income and expense profiles are very different for business and individual customers: incomes for business owners can be quite variable in comparison with the fixed incomes of salaried customers. In addition, home loans have the house as security over the loan and so the potential loss to the bank is lower than a personal loan where there may be no security at all.

The key areas where business pricing will differ from home lending pricing are:

> **Cost of funds** – typically the amount of deposits that businesses have is less than the amount of lending, and so banks must rely on wholesale funding to have the capital to lend to customers. The increase in wholesale funding costs due to the global financial crisis forced increases in interest rates on all lending. The commercial lending portfolio sources the majority of its funding from the wholesale market and so has been exposed to a greater level of increasing costs.

Probability of default - History has proven that small business enterprises have a higher probability of default compared with retail home loan customers. A higher risk margin is therefore required on business loans to cover this increased risk. The difference between the home loan rate and business rates which are secured by residential property is a direct result of the higher probability of default experienced by the banks in the small business sector.

Loss Given Default - Small business customers also tend to have a higher loss once default has occurred. A factor driving this higher loss is the wider range of security options (farms, commercial property, equipment, etc) that banks accept as security on small business loans

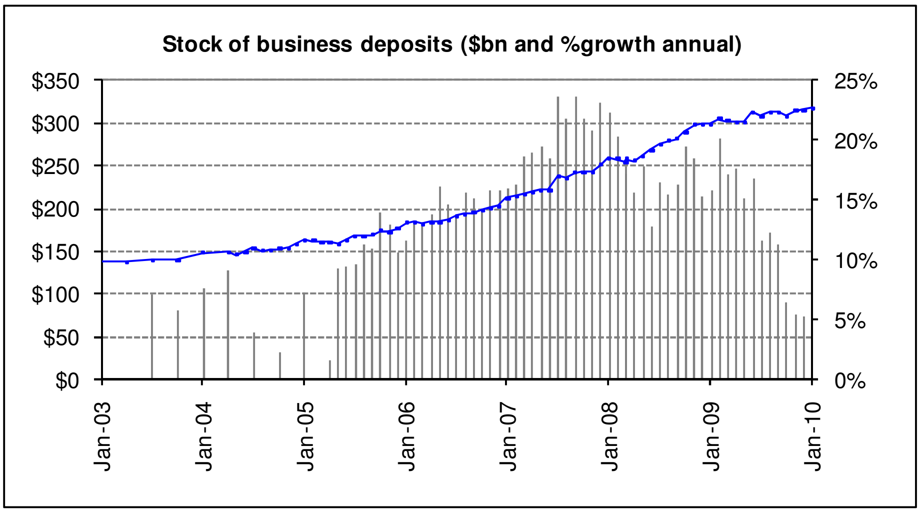
Banks are effectively making an investment in small businesses via lending facilities they provide. In order for a bank to make a sound and prudent investment in their business, owners need to demonstrate that they understand their business, have suitable controls and strategies in place and are prepared to work to ensure the viability of their business.

4. Access to funding

4.1 Bank funding

ABA member banks are well capitalised, and bank funding programs have recovered well from the contraction in the capital markets in the second half of 2008.

For example, there has been strong growth in deposits[9]. The stock of business deposits held with ABA member banks grew by 6.3% or $18.9 billion over the 12 months to the end of January 2010. Business deposits are now at $318.0 billion.

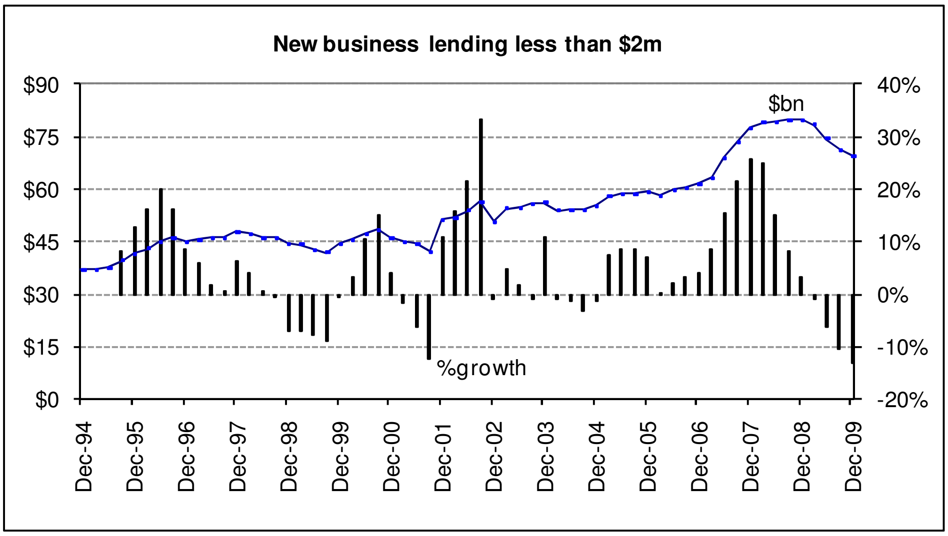


[10]

[9] APRA data
[10] Source: APRA

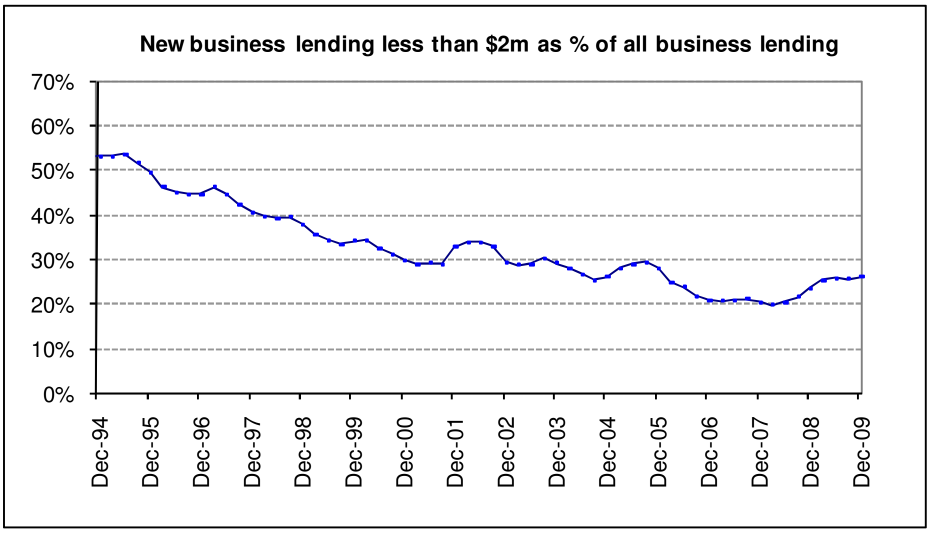
4.2 New loan commitments to business

Despite falling from the high levels achieved during 2008, new loan approvals under $2 million reached $69.6 billion over the 12 months to the end of December 2009. This is 12.9% or $10.3 billion lower than for the previous year. A record level of $79.9 billion was reached over the 12 months to the end of December 2008.



[11]

After falling to a low of 19.9% over the 12 months to the end of March 2008, new business lending of less than $2 million, as a proportion of all new business lending, increased to 26.2% for the 12 months to the end of December 2009. This is the highest percentage in four years.

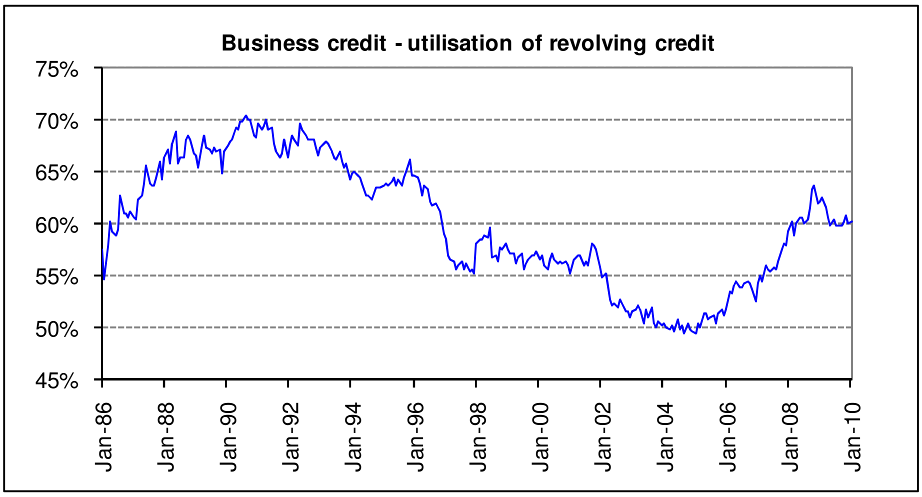


[12]

[11] Source: RBA
[12] Source: RBA

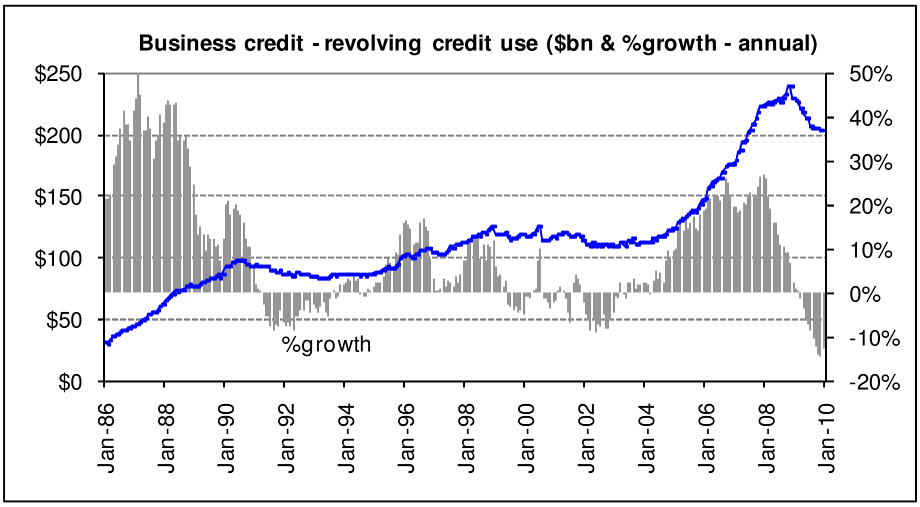
4.3 Credit utilisation – revolving credit

ABS lending finance data at the end of January 2009 show that businesses are using 60.2% of the revolving credit available to them. Businesses are using $199 billion of a total of $330 billion of their credit limit.



[13]

Use of revolving credit grew strongly over the three and a half years to mid-2008. While it has been falling throughout most of 2009, at $199 billion, it still remains at high levels.



[14]

4.4 What business can do

For the business owner, they key factor in accessing credit is the quality of the credit application.

The objective of preparing a credit application is for the business owner to show the bank that they run a viable business and therefore, that providing a business loan has an acceptable level of risk.

[13] Source: ABS
[14] Source: ABS

One of the most important objectives of the application is to demonstrate to the bank that the business owner can fully express their business plans and needs in writing and can support them with financial information.

Bankers will focus on the plan to generate free cash flow. Healthy cash flow is the essence of a successful small business, and is necessary to support loan repayments.

Security is also crucial to the application, and will form the basis of the loan agreement.

For more detail, see:

http://www.bankers.asn.au/Default.aspx?ArticleID=1353.

5. Competition

Undoubtedly, the global financial crisis has meant that there is less choice. Some players have left the market, and others have had to fill the gap.

But that doesn't equate with a lack of competition. In the last 12 months for example, we've seen the banks slashing a whole range of fees, which they would never have done unless they were competing fiercely for customers.

5.1 Products and pricing

There is strong and healthy competition in the small business market, with a wide variety of product and pricing options.

For example Cannex data (for 26 March 2010[15]) for a business term loan, secured by residential property, lists 67 products and 26 providers. The published interest rates vary from 6.04% to 10.95%. Of the 20 lowest rate products, 15 are from ABA member banks.

For business deposit accounts, 53 products are listed from 31 providers. Of the 20 highest rate products, 12 are from ABA member banks.

The Reserve Bank has recently commented on competition in the deposit market:

> *Within the deposit market, competition has been strongest for term deposits, which account for about 40 per cent of the major banks' deposits and about 55 per cent of the regional banks' deposits. The average rate on banks' term deposit specials – the most relevant rate for term deposit pricing – is currently about 140 basis points above money market rates over equivalent terms, whereas in the few years prior to the global financial crisis it was generally about 60 basis points below it. The banks have been offering significantly higher rates across all of their term deposit specials, from 1 month to 5 years.*[16]

[15] http://www.canstar.com.au/
[16] http://www.rba.gov.au/publications/bulletin/2010/mar/6.html

…and on lending, has observed that:

> *Reduced lending by the smaller banks and the non-bank financial institutions appears to have been the main factor in the easing in competition in the recent cycle…*[17]

5.2 Product innovation

Competition in small business banking has led to many innovations in product development and service delivery. For example, small businesses can take advantage of a broad range of electronic banking offerings, including:

5.2.1 Direct Debits & Credits

The small business owner can authorise a bank to take money from their account on a regular basis to pay regular bills, or have someone else make automatic payments into the account

5.2.2 Internet Banking

Internet Banking is one of the cheapest ways for a business to do their banking. The small business owner can pay bills, pay employees and contractors, and manage their accounts – from an Internet connection anywhere in the world.

Some banks' Internet Banking services allow transfer of information into popular financial management programs such as Quicken and MYOB.

5.2.3 Internet Payment Solutions

Banks are providing services aimed at online retailers and other companies providing services and products that generate payments over the Internet.

Various products available allow a business to receive Internet payments from overseas and process payments from their own computer.

6. Lending and financing options

Small business customers have a wide range of banking products and services from which they may choose, at competitive rates, and a wealth of advisory and information services on diverse matters such as business planning, cash flow management, export advice, succession planning and agribusiness management.

Whether for cash flow and liquidity, or growth and investment, small businesses turn to banks, for overdrafts, business loans, asset finance, trade finance, or business credit and charge cards. Some businesses seek specialised services such as debtor financing.

In choosing the right loan or the right account, small businesses will consider a range of features, including fees and interest rates. The small business banking market is highly competitive, and it pays to shop around. The banks themselves provide a wealth of information, the ABA has an information site for small business (www.smallbusinessbanking.com.au) and there are third part information services such as Cannex (Find Rates & Compare Home Loans, Credit

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[17] RBA submission to Inquiry, p.6

Cards, Car Insurance, Savings Accounts, Star Ratings) and Infochoice (Financial comparisons and information from Infochoice - make informed choices).

In relation to fees and charges, there is wide range of choices available. Banks provide specific information on their web sites on how to minimise fees – by account selection, taking advantage of electronic banking, bundling transactions and planning ahead. There are accounts available with significantly lower fees and free transaction features.

Some banks offer micro-finance solutions with minimal or no interest, or specialised products for particular market segments such as agribusiness.

Banks provide a very wide range of lending and financing options to small business, and there are other choices available from non-banking financiers. The major categories are described below.

6.1 Debt finance

Debt finance is lent by the provider for an arranged rate of return (interest). After internally generated finance, it is the major source of finance for small businesses.

Traditional debt financing products include overdrafts and term loans.

6.1.1 Overdrafts

Overdrafts comprise an extension of credit by a lending institution to cover the amount by which withdrawals exceed deposits in a current account.

Cash flow is the lifeblood of any business, and daily cash flow is critical to business success. For small businesses there are times when cash flow is tight, for example, due to seasonal fluctuations, unforeseen circumstances, or a slowdown in the operating cycle.

An overdraft is a convenient and flexible way to cover the day-to-day spending; help cash flow run smoothly and make it possible to take advantage of opportunities (such as supplier discounts for immediate payment) as they arise.

6.2 Term loans

Term loans may also be known as "fully drawn advances".

They are for a fixed term, which can be for a number of years if the business is regarded as stable. A schedule of repayments is generally required over the term of the loan.

6.3 Alternative debt products

An extensive range of debt finance products has evolved to meet small business financing needs.

Many of these have been developed to extend access to capital to the maximum extent possible within the constraint of a small business's capital structure (a sustainable mix of debt and owners' capital).

6.3.1 Hire purchase and chattel mortgage

A Hire Purchase Agreement is a contract which allows small businesses to purchase goods over a predetermined period with guaranteed ownership at the end.

Equity is increased with each payment and the business may decide to purchase at any time during the contract. Monthly payments can be structured to suit cash flow, and a deposit may be paid if so desired.

6.3.2 Leasing

A lease is an agreement whereby an owner, the lessor, rents goods to the small business, the lessee, who uses the goods to earn assessable income. The user must show the lease on their balance sheet as an asset with a corresponding liability.

Finance lease agreements must have a residual or lump sum, which represents the potential sale price of the goods at the end of the lease term. At the end of the lease term the user must pay the residual amount. This can be done by re-leasing for another term, offering to buy the asset (usually for the amount of the residual), or trading the asset for a replacement and paying any shortfall or keeping any profit.

In most cases, lessees can claim the full amount of the rental payments as tax deductions.

6.3.3 Factoring

Under a factoring facility the financial institution effectively buys the outstanding sales invoices of the small business.

When the business needs to draw funds the financial institution will pay up to 90% of their value. The debtors then pay the sales invoice, when due, directly to the financial institution, and it refunds the remaining 10% to the small business.

Factoring means that the small business can use its debtors to finance new orders, buy raw materials, or even expand the business, without taking on new borrowings or mortgaging real estate assets.

The facility also effectively outsources debtor administration to the financial institution.

6.3.4 Invoice discounting

Invoice discounting is a confidential finance service that has been developed to meet the working capital requirements of growing companies.

The service provides a line of credit whereby companies can use their outstanding debtors in a more productive manner in order to achieve profitable growth.

Invoice discounting allows funds to be drawn as required up to the limit determined by sales invoices accepted by the financial institution. As accounts are settled the outstanding amount is reduced. Interest is paid only on the daily balance, resulting in lower interest costs than many fixed finance arrangements.

6.4 International trade finance

Banks, government agencies, and other financial services institutions provide a range of specialist services for businesses involved in international trade.

This finance generally takes the form of overdrafts or term loans.

It can be arranged in foreign currencies as well as in Australian dollars. Loans of this type can be in the form of a multi-currency facility that allows the borrower to switch between currencies.

6.4.1 Importers

Banks offer finance to small businesses to cover occasions where an overseas supplier requires payment before shipment, or on immediate receipt of the imported goods.

Banks establish the credibility of the small business with an overseas supplier by means of a guarantee with the exporter's bank.

6.4.2 Exporters

Export finance is ideally suited to producers who supply products to an exporter. It provides the small business with interim finance from the time of sale to the time the exporter pays for the goods.

To facilitate cash flow, the small business can, at the time of delivery to the exporter, receive up to 85% of the value of the products supplied, without the need for further security.

6.5 Other sources of finance

6.5.1 Mortgage loans

These are loans provided generally by non-financial institutions such as accountants, solicitors, and investment companies.

They are generally short term in nature (1-2 years) and may be used by small businesses having difficulty accessing finance through financial institutions.

6.5.2 Equity finance

Equity finance (owners or investors) is the key to a business maintaining a sustainable capital structure. If a small business does not have access to the levels of equity finance they need to sustain their capital structure, they will have problems accessing debt finance. Access to equity finance is essential to start up businesses or to assist existing businesses to grow. It is more likely to be important either at the very early stages of a business growth cycle, or at key stages of expansion.

This finance is often invested in the business for a share of the business profits. Investors of equity capital expect higher returns than the cost of debt finance because their capital is at risk of poor performance by the business.

6.5.3 Business angels

Typically a wealthy individual provides start-up capital to very young companies to help them grow, taking a large risk in exchange for a potentially large return on investment. Many are successful former entrepreneurs who want to help other entrepreneurs grow their business.

6.5.4 Venture capital

Venture capital funds are made available through corporations or financial companies for start-up firms and small businesses with an exceptional growth potential. Managerial and technical expertise is often also provided.

7. Information for small business

Banks support their customers with a wealth of information and business-specific services, for example, by holding small business forums and undertaking business 'health checks'. Banks have also assisted small businesses affected by natural disasters with special assistance packages and other services.

ABA has its own Small Business Forum, whose members include small business owners from across Australia, and has held forums with Minister Emerson, COSBOA and with specific industry groups. The ABA's approach has been consultative and collaborative, receiving information and responding with information and data, and engaging with its member banks on issues raised.

Banks and the ABA together have committed to exploring ways communication can be enhanced with the small business sector. Information provided via fact sheets to the sector was considered to be the most efficient way of disseminating the information.

The ABA has developed a range of fact sheets, which are published on its web sites, and provided to small business organisations so that they can forward to their membership.

See for example:

http://www.smallbusinessbanking.com.au/Home/default.aspx

http://www.smallbusinessbanking.com.au/Banking-Industry-Fact-Sheets/default.aspx

http://www.smallbusinessbanking.com.au/The-Buzz-/default.aspx

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