
Lending to small business

Supplementary submission to the Senate Economics Committee Inquiry into Access of Small Business to Finance

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Recently The Australia Institute published a paper on bank profits,¹ which has been forwarded to the Committee. The following briefly summarises the paper before adding some additional observations, including some more specific comment on lending to business.

Summary of the bank profits paper

Despite the setback due to the global financial crisis, the profits of the big four banks have been gradually increasing from one per cent of GDP 20 years ago to around two per cent today—and they would have been higher still if not for the global financial crisis.

Adjusting for the impact of the global financial crisis, it is estimated that in the 2009 financial year the big four banks earned underlying profits before tax of \$35 billion or just under three per cent of GDP. It means that of every dollar spent in Australia, three cents end up as underlying profit of the big four.

If banks were earning more normal returns on their equity, their profits would be much lower. In more competitive industries returns of around 10 per cent are more likely. It is estimated that around \$20 billion is the additional underlying profit that banks earn as a result of their market power.

Part of the reason for the huge profits of the banks is the high degree of concentration in the financial market generally. In the early 1980s banks accounted for 50 per cent of all lending in Australia. Today it is over 90 per cent as the banks became stronger during the period of deregulation. The result of the tendency for increased concentration is that the big four banks have increased their share of banking itself. The big four now have 76 per cent of the banking market.

A good example of the exploitation of market power on the part of the banks follows the increases in official interest rates by the Reserve Bank of Australia (RBA). Objectively bank costs have not changed from one day to the next but the banks use the official interest rate decisions as cover to increase their interest charges. At most, around half of bank deposits and borrowings are market related, or at least potentially affected by changes in official interest rates and then with a long lag. Only a fraction of banks' borrowings reflect the actual official interest rates that rule in the money market.

So far, Australian policy-makers have used competition as their main weapon against the banks. Almost a century ago, the Commonwealth Bank was established as a people's bank to provide genuine competition against the private banks. Since then, there have been waves of competition coming from the credit unions, building societies, finance companies, mortgage originators and the foreign banks. Despite a century of competition, the big four banks are as strong now as they have ever been.

¹ D Richardson, *A licence to print money: bank profits in Australia*, The Australia Institute Policy Brief No. 10, March 2010. Available at <https://www.tai.org.au/index.php?q=node%2F19&act=display&type=1&pubid=733>

Clearly competition and deregulation have not worked. It is time to use other weapons against the banks. The Finance Sector Union has called for a social contract with the banks. To reinforce the social contract there should be tough regulation that gives everyone access to low-cost banking. Fees and charges should be controlled so that they represent actual costs and no more.

Impact of increases in official interest rates

The bank profits paper briefly discussed the increases in bank interest rates following RBA actions. Generally, the community regards it as normal that banks change interest rates in line with changes in official interest rates. It seems to be generally taken for granted that increases in official interest rates increase the costs to banks and so they are justified in increasing their interest charges on their lending.

For monetary policy the RBA expects interest rates to be passed on so that changes in the official interest rates flow through to influence the whole structure of interest rates throughout the economy.

The paper mentioned that following the March 2010 interest rate increase not all of the rates on banks' liabilities increased. Overseas lending was unaffected as was the bulk of retail deposits where most accounts attract zero or near zero interest.

Bank expenses on borrowings from abroad

To examine overseas interest expenses, the following table was constructed from balance of payments data. The table takes investment income payable abroad by Australian 'depository corporations' and compares them with the investment levels in 'deposit taking corporations'.² A problem here is that the ABS figures do not separate out the figures for banks and other deposit taking institutions. However, we can be confident that the big Australian banks are responsible for the bulk of overseas borrowing. Moreover, the rates the big banks pay would be at least as low as the average paid by all banks and other deposit taking corporations.

Table 1: Interest expenses on banks' overseas loans

	Inferred interest rate on overseas bank borrowings (%)
Mar-2008	5.18
Jun-2008	5.00
Sep-2008	4.75
Dec-2008	4.77
Mar-2009	4.62
Jun-2009	4.52
Sep-2009	3.90
Dec-2009	3.92

Source: ABS, Balance of payments and international investment position, Australia, Dec 2009, 1 March. 2010.

² These are the actual definitions used by the ABS.

This table shows very clearly that there was some small early increase in borrowing rates reflected in the December 2008 figures but, generally, following the financial crisis interest, expenses fell and over the last two quarters shown in the table interest expenses have been stable at just under four per cent. It seems safe to conclude that there has been no cost pressure coming from banks' overseas borrowings. Although there are no data yet for 2010, overseas interest rate figures published by the RBA suggest there has been no increase in funding costs.

Term deposits

Banks often refer to the competition driving up interest rates on term deposits. The following figures are taken from the RBA and show average term deposit rates available from the big four (including St George in Westpac).

Table 2: Interest rates on term deposits

	Banks' term deposits (\$10 000)				
	1 mth	3 mths	6 mths	1 yr	3 yrs
Dec-2009	1.60	3.65	4.35	6.00	7.00
Jan-2010	1.60	3.65	3.20	5.95	7.00
Feb-2010	1.60	2.85	3.15	5.95	7.00
Mar-2010	2.35	3.30	3.45	6.00	6.60

Source: RBA Statistical Tables.

The table is interesting showing that interest rates have indeed increased in the case of one-month and six-month deposits but have fallen in the case of three-month rates and three-year rates. Where the short-term rates have increased, they are still well below the official interest rate. Published rates are not the amount people necessarily receive. The RBA also publishes a figure for the average special rate based on banks' advertised special rates. Those have been 6.15 per cent but reduced to 6.05 per cent in March.³ Clearly there is no trend in movements in term deposit rates since the March interest rate increase.

Other deposit rates

Some business deposits earn rates of interest that have moved with the March increase in official interest rates. For example, rates on bank bills, money market deposits, swap rates and some others seem to reflect changes in interest rates. These are unlikely to be a third of bank deposits. Hence it appears that when banks lift their loan interest rates across the board, their profits are likely to increase by perhaps two thirds of the burden they impose on home buyers and other bank customers.

So how much of the official interest rate should be passed on?

If the banks were able to increase interest rates by 0.25 per cent on all their lending, the interest income of the big four banks would increase by \$3.8 billion. Assuming

³ RBA Statistical Tables.

they have to increase interest rates on a third of their liabilities, annual profits of the big four would increase by approximately \$2.2 billion. However the bank profits paper has shown that bank profits are already too high. If banks cannot absorb the interest rates, only about a third of the increase should be passed on so as to leave their profit unchanged.⁴ It would be useful if there was better information so that the exact pressure on bank costs could be calculated. Perhaps the Senate could recommend that the RBA collect and publish additional information on bank costs so that their claims could be verified or refuted.

The clear impression from watching bank interest rate changes is that official interest rate changes are taken as the signal to change bank lending rates whether bank costs justify an increase or not. It looks like a textbook example of oligopolistic pricing in which the main players set a common price to maximise their collective earnings. Usually explicit collusion to set prices is illegal but there is implicit collusion that may take other forms. For example, one firm may emerge as the price leader occasionally announcing changes in prices that are copied by other participants in the market. Price leadership itself is not illegal even if the end result is the same as illegal collusion. As the Australian Competition and Consumer Commission (ACCC) points out

Price leadership will not breach the [Trade Practices] Act, as there has been no agreement between the parties. One business has simply chosen to follow the lead of another. As a result, there was no requisite 'meeting of minds' between the parties, even if one business consciously chose to follow the prices set by another.⁵

In the case of banking, it is actually the RBA that acts as an unofficial price leader. The RBA announces interest rate changes which are followed by the banks, at least on their lending side. Hence the RBA acts as the price leader and the banks follow the leader irrespective of their costs. It is relatively rare that banks change lending rates independent of movements in official rates and usually they change rates by the same amount as the change in official rates. So the RBA determines both the timing and quantum of changes in bank lending rates.

This should not be taken as a criticism of the RBA. It is their job to influence the structure of interest rates throughout the economy and the chief tool is the official rate that determines rates in the short-term money market. From there the RBA expects that rates elsewhere will gradually adjust in line with the short rates. The point to be made here is that the banks have sufficient market power to automatically follow the RBA irrespective of their own costs. Moreover, they are able to adjust their interest charges immediately but the rates on many of their deposits are adjusted slowly, if at all.

⁴ The exact figure will differ among banks depending on their funding mix. In a more competitive market there would also be pressure on the banks to have a relatively uniform funding mix.

⁵ ACCC, *News for Business*, 1 January 2007, at <http://www.accc.gov.au/content/item.phtml?itemId=716949&nodeId=6744d253c6d765ba2a33a5ceac30049a&fn=News%20for%20business%E2%80%94price%20fixing.pdf>

Of course, the Australian Bankers Association (ABA) insists that banking is a very competitive industry and banks do engage in a lot of competitive behaviour. However, this form of competition involves advertising, product differentiation, bundling of services and the like. Competition by way of price cutting is eschewed. Indeed, given the various fees and charges that apply, it is usually very difficult to determine the effective interest rate on a particular bank product.

The way banks set and change their interest rates in response to the RBA is interesting and important in its own right. However, it is also an indicator of how the banks exercise market power.

Incidentally, following the bank profits paper, the ABA took issue with my reference to the banks exploiting their monopoly power. According to the ABA, there is more than one bank so the word 'monopoly' should not be used. For our purposes, the word 'monopoly' was used to convey the impression of oligopolies acting as one in matters such as pricing. However, this is really a definitional matter and a distraction from the main point.

Lending to small business

The following table examines bank lending commitments to business over the course of the recession.

Table 3: New lending commitments (\$ million)

	Small business loans (up to \$2 million)	Large business loans (over \$2 million)	Total
Mar-2008	16532	73688	90221
Jun-2008	22972	62435	85408
Sep-2008	20212	59061	79273
Dec-2008	20196	61047	81243
Mar-2009	15048	45081	60129
Jun-2009	19061	45670	64730
Sep-2009	17077	53472	70549
Dec-2009	18393	51690	70083

Source: RBA Statistical Tables.

The table confirms suspicions that the banks contracted all their business lending following the global financial crisis. Large and small business were both affected. The following table presents total loans outstanding to confirm the impression given by new lending commitments.

Table 4: Bank loans outstanding (\$ million)

	Small business loans (up to \$2 million)	Large business loans (over \$2 million)	Total
Mar-2008	196223	443037	639261
Jun-2008	199841	449745	649585
Sep-2008	203375	476530	679905
Dec-2008	202727	498824	701550
Mar-2009	197597	513439	711036
Jun-2009	201111	489927	691038
Sep-2009	200662	475109	675770
Dec-2009	200530	469897	670427

Source: RBA Statistical Tables

It is apparent from bank loans outstanding that lending to all business contracted following the global financial crisis. However, for small business there was less of a contraction, rather lending growth slowed down. (Bank lending to small business had grown by 8.0 per cent per annum in the 9 years to Mar 2009.)

The following table looks at the cost of small business loans and compares them with the cash rate (official interest rate set by the Reserve Bank) and the average cost of funds for the big four banks. Note that in the absence of better data we are forced to take small business loans as a proxy for loans to small business.

Table 5: Interest charges on small business loans (%)

	Small business loans		cash rate	margin v cash rate
	variable overdraft not residentially secured	small overdraft		
Mar-2008	11.20	11.85	7.22	4.30
Jun-2008	11.45	12.10	7.25	4.53
Sep-2008	11.45	12.05	7.02	4.73
Dec-2008	9.95	10.50	4.35	5.88
Mar-2009	8.95	9.50	3.25	5.98
Jun-2009	8.80	9.40	3.00	6.10
Sep-2009	8.80	9.40	3.00	6.10
Dec-2009	9.55	10.10	3.74	6.09
Jan-2010	9.55	10.10	3.75	6.08
Feb-2010	9.55	10.10	3.75	6.08
Mar-2010			4.00	

Source: RBA Statistical Tables; APRA Statistics, *Quarterly Bank Performance, September 2009*, 26 March 2010.

The table clearly shows that against the cash rate, small businesses are paying a large margin and a margin that has been increasing significantly since the global financial crisis. Against the cost of funds for the big four, the margin has been more consistent tending to hover a bit over six per cent, with the exception of the early onset of the global financial crisis.

It might be more appropriate to compare the margin applying to small business with the banks' overall costs and margins. However, the figures are much older. Based on APRA figures, the actual average cost of funds was 2.77 per cent and the margin over all the banks' business was 2.13 per cent in the September 2009 quarter, the latest figure we have.⁶ However, the variable overdraft rate charged to small business was 11.45 per cent, implying a large margin of 8.68 per cent on small business loans of that type, much higher than the average margin of 2.13 per cent over all bank lending, which implies a penalty rate on small business of around 6.5 per cent.

A penalty interest rate on bank loans may be justified if there were a very high failure rate on bank lending. A 6.5 per cent margin on small business loans suggests around 6.5 per cent of those loans will go bad every year. There is of course no data on small business loan failures. However, for the four big banks as a whole, the total charge for bad or doubtful debts in the year to September 2009 was \$14,573 million, or just 0.67 per cent of total liabilities.

⁶ APRA Statistics, *Quarterly Bank Performance, September 2009*, 26 March 2010. The figure in the text is calculated as the total net interest income for the big four banks divided by their total liabilities.