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9 February 2011

Mr Ian Holland
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT

Dear Mr Holland,

The Westpac Group is pleased to provide a submission to the Joint Parliamentary Committee on Corporations and Financial Services regarding the Committee's Inquiry into Access for Small and Medium Business to Finance. In retail and business banking operations, the Westpac Group comprises Westpac, St George, BankSA and RAMS. This submission focuses on the Small and Medium Enterprise (SME) finance businesses of Westpac and St George.

Overview

No current discussion of business lending is complete without considering the impact of the global financial crisis on the Australian banking market. While some now consider that the financial crisis has quickly become an historical footnote given the recent performance of the Australian banking sector, it is clear that the GFC has resulted in a fundamental change in wholesale funding markets. It has made funds harder to obtain and more expensive to lend across the wider banking system. This has had consequences for the price of credit for all market segments.

The financial crisis tested and, in some cases, exposed the unsustainable business models of lending institutions, which in turn impacted the structure of the lending market. Access to wholesale finance through international capital markets or securitisation has been curtailed for some smaller and non-bank lenders who don't have a deposit base to draw funding from, either increasing sharply the cost of funds for these lenders or causing them to exit the market.

Through careful management and within the context of a robust regulatory system, the Westpac Group remained 'open for business' through the financial crisis and has continued to invest in the SME market segment.

In the last 18-24 months, the business lending cycle saw a drop in demand for credit and a period of small business 'de-leveraging' coinciding with an increase in the cost of funds. Over time, as the economy strengthens and funding markets stabilise, conditions will improve for SMEs. Indeed, this is already beginning to occur.

Throughout the financial crisis, the strength of Australia's prudential regulation was evident in the low lending default rates and the ability of some major banks to continue lending through the crisis. This regulatory framework will continue to play an important role in ensuring a stable banking system, while new Basel III reforms will build on this platform. Any consideration of changes to prudential standards for the policy goal of boosting lending needs to ensure an unacceptable increase in systemic risk is avoided and incentives for risky behaviour, which can ultimately only damage the entire Australian economy, are minimised.

This submission will address terms of reference 1, 2, 4 - 9.

Review of most recent submissions

Westpac provided a submission and appeared before the Senate Economics Committee's Access of Small Business to Finance Inquiry in 2010, setting out our views on the state of the small business lending market and the challenges faced by small businesses. The key themes of that submission were:

- that the Westpac Group remained 'open for business' and continued to lend through the downturn, when other lenders were withdrawing from the market;
- the slight decline in applications for credit was a result of weakening economic conditions through the business cycle; and
- the financial crisis, which included a dramatic increase in the cost of wholesale funding, saw the exit from the market of smaller, non-ADI lenders whose business models proved unsustainable.

More recently, Westpac participated in the Senate Economics Committee's Inquiry into Competition in Banking, providing a written submission in December 2010 and appearing before the Inquiry in January this year. The key themes of Westpac's submission to that Inquiry were:

- the strength of the Australian banking system due to strong regulation and sensible management;
- WBC lent through the crisis;
- Wholesale funding costs have increased, affecting the whole economy; and
- Government intervention can assist but cannot return us to pre-financial crisis.

Definition of small and medium business

The definition of 'SME' varies across the Westpac Group. For example, within Westpac, an SME is generally classified as a business with up to $1million in business lending and up to $2million in total borrowings. In contrast, at St George, businesses with lending of up to $1million or turnover of between $1-$5million are managed as SME customers. Westpac and St George's different approach to the SME market is part of the Westpac Group's multi-brand strategy.

TERMS OF REFERENCE – THE WESTPAC GROUP RESPONSE

1. **The types of finance and credit options available to small and medium businesses (SME) in Australia**

Across the Westpac Group, SME banking products and services are offered by Westpac, St George and BankSA. Westpac business lending products include business credit cards, loans (short term loans, long term loans, equipment finance and leasing and agribusiness), merchant services and international trade products.

St George offers a similar range of business credit cards, loans and credit facilities.

2. **The current levels of choice and competition between lending institutions, but not limited to, credit availability, fees, charges, comparative interest rates and conditions for business finance;**

Australian businesses are served by a broad range of banking service providers who provide a real choice for borrowers. APRA statistics show that there are over 170 entities competing in the Australian banking market, including domestic and foreign banks, mutual building societies and credit unions and other ADIs. Additionally there are a range of non-ADI finance companies which compete with ADIs in the credit market.

Competition in business lending continues to be intense, notwithstanding the slight drop in demand for credit through the financial crisis. It is our experience that this decline in credit applications was driven by cautious and prudent de-leveraging by customers anticipating the economic downturn. Examples of this competition can currently be seen in the lowering of the price of credit and non-price lending criteria by some players for financially sound customers.

3. **The impact of financial institution prudential requirements and banking guarantees on lending costs and practices;**

Australian prudential regulation impacts banks' costs and lending practices by discouraging lenders from engaging in risky lending behaviour. In our experience, this regulation is appropriate and important for the safety and stability of the Australian financial system. The consequence of a weak regulatory system, together with systemic mis-pricing of risk, was seen in the financial crisis of 2008 and its aftermath.

A comparison of the capital requirements of residential lending and business lending highlights the disparity in the cost of lending to business. Capital reserves required are three times higher for business lending than residential loans, reflecting the increased risk inherent in business loans. Although extremely low by international standards, nevertheless the default rate of business loans is approximately two-and-a-half to three times higher than for residential loans.

4. **Comparison between the credit options available to SMEs located in regional Australia and metropolitan areas;**

Westpac Group SME business credit options are not affected by geographical considerations. As one of Australia's largest financial institutions, the Westpac Group has business bankers in every state and territory across Australia offering a full range of business lending products to customers. Agribusiness lending products and bankers focus almost exclusively on the specialised lending needs of agricultural-based businesses.

The Westpac Group's recent investment in new business banking centres and additional customer-facing staff underscores Westpac's regard of the SME customer sector as a strategic growth priority.

Our grassroots banking strategy – 'bringing back the local Bank Manager' – gives local branches the power to better support their local communities and customers. Westpac has created over 1,300 new banking roles in the past two years, including bank staff, Bank Managers and regional managers, while additional commercial bankers provide business support to local businesses

Pursuing a similar strategy, St George has also boosted its numbers of SME relationship managers in the past two years. The Business Mentoring program, the creation of Small Business Experts and 24 hour a day, seven days a week operation of the business support centre highlights this approach.

5. **The impact of lenders' equity and security requirements on the amount of finance available to SMEs;**

At the Westpac Group, credit decisions are determined on the basis of a customer's ability to repay their loan through cashflow, rather than solely on the value of the security provided by the customer against a loan. The soundness of this approach is shown in the low business lending default rates across the Westpac Group.

If an SME customer meets the credit criteria, the pricing of their credit facility takes into consideration a range of factors including expected losses (and provisioning), the capital required to be held against the loan, the costs of originating a new loan and the cost of funding this loan. A risk grade is attached to new customers, which determines the expected losses and capital requirement, while existing customers would likely already have a risk grade.

During the past two years, Westpac has made no major changes to key credit policies relating to debt service cover, interest cover, Loan-to-Value-Ratios (excluding commercial property) or other credit policies.

Our view of the SME lending market is that access to finance for some companies has been affected by the withdrawal of smaller financial companies from business credit markets. Weaker business conditions during the past two years have also meant an increase in applications falling short of underwriting standards, correlated with an increase in credit bureau default rates for SME customers applying for credit. We expect this to change as credit markets continue to stabilise and business conditions improve.

The Westpac Group is aware of certain community views that suggest the price of business credit is unreasonably higher than for residential credit, given that, in many cases, the security is often the same, being a residential dwelling.

However, slightly higher interest rates for SME lending when compared to residential mortgage lending is consistent with the performance of SME loans across Westpac Group portfolios. Currently, small business '90 days+' delinquency rates are approximately two-and-a-half to three times greater than that of residential mortgages. Further, SME borrowers have a significantly higher net bad debt rate when compared to the consumer mortgage portfolio. In response to calls for banks and other lenders to engage in more asset-based lending, it is worth noting that this practice is heavily discouraged, if not prevented under consumer credit laws applying to retail consumers, on the basis that the practice is often, in practice, deemed unconscionable.

6. **Policies, practices and strategies that may restrict access to SME finance, and the possible effects this may have on innovation, productivity, growth and job creation;**

Aside from Australia's strong and sensible prudential regulation, which recognises that loans to the small business sector are statistically more risky than home loans and requires banks to assess such loans accordingly, we are not aware of any specific policies, practices and strategies restricting access to SME finance.

7. **The need for any legislative or regulatory change to assist access by SME to finance; and**

Legislative or regulatory intervention may provide some limited relief for SME borrowers who cannot already access finance in today's market. However, we do not see such intervention as a panacea.

As we have outlined in previous submissions, the elevated cost of wholesale funds in the wake of the financial crisis is due in large part to re-pricing for risk. The experience of the financial crisis in Australia shows that strong prudential standards have contributed to the strength of the Australian banking system.

Current prudential standards recognise that loans to the business sector are statistically more risky than loans to homeowners secured by residential property; we endorse this prudential framework. We would caution against material weakening of prudential regulation for banks, which would have a wider, likely negative effect on the banking system.

Our recommendations for change are those proposed in our submission to the Competition in Banking Inquiry. These include:

- create a framework to allow covered bonds to be issued by Australian Authorised Deposit-taking institutions
- strengthen the Residential Mortgage-Backed Security market through continued Australian Office of Financial Management investment
- allow master trust format for securitisation of alternative asset classes.

While not SME specific, these proposals will assist in diversifying the supply of funding for the entire lending market, which should have a downward effect on price and availability of credit.

8. **Any other related matters**

a) **How we assist our SME customers**

Westpac launched its Assist program in 2007 and extended it to SME customers in 2009. Westpac Business Assist provides personalised support to SME customers. These programs provide specialised support to SME customers experiencing financial difficulty. St George has offered a similar since 2009.

In the first 12 months of this service, which coincided with the aftermath of the financial crisis, the Westpac Business Assist team took over 10,000 calls. At this stage in the business cycle, this increase in financial distress was not unexpected, and the Westpac Group's proactive approach allowed us to provide targeted and necessary support to customers in need.

In addition to financial hardship support, the Westpac Group's SME customer strategy extends to coaching and business education. In 2010, business workshops and seminars were boosted by more than 15 per cent, enabling over 8,000 customers and non-customers to attend expert sessions on issues such as cash flow, business planning and the economy.

Conclusion

The Westpac Group remains open for business. Our goal, to be the leading bank in the SME market, has meant we have invested heavily in front line services to assist new and existing customers. We remain committed to supporting our SME customers in a prudent and sustainable manner for the long term benefit of our customers and the Australian banking system.

Yours sincerely,

Brett Gale
Head of Group Government & Industry Affairs
Corporate Affairs & Sustainability