Inquiry into Access of Small Business to Finance: Answers to supplementary questions

May 2010

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1. Introduction

This paper responds to questions on notice from the Australian Bankers' Association's (ABA) appearance at the 12 April hearing of the Senate Economics Reference Committee's *Inquiry into Access of Small Business to Finance.*

The answers to the questions below refer to, and should be read in conjunction with, the ABA's submission to the Inquiry dated 31 March 2010 ("the submission").

Key points from the submission included the following:

1.1 Access to finance

Banks' doors are open and they are lending to viable businesses. At the end of January 2010, the stock of lending to business by ABA member banks was $368 billion, an increase of more than $52 billion from the beginning of the global financial crisis.

Australian Bureau of Statistics data shows that the demand from small business for new lending has been falling and the Reserve Bank has noted that small businesses have scaled back their capital expenditure and focussed on reducing their existing debt.

1.2 Cost of finance

Since the credit crisis started, 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. This pressure is affecting the prices of all loans including small business.

Interest rates for most small business products increased by 70 – 80 basis points from October 2009 to February 2010 (the period used in the submission). The Reserve Bank's cash rate moved 75 basis points over that same period.

1.3 Prudent lending

It continues to be vital to the long-term health of the Australian economy that banks apply risk-based pricing in relation to lending to small business.

Throughout the global financial crisis and as we continue to experience its impacts, banks have rightly re-priced for risk over the last 12 – 18 months in relation to their small business customers.

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.

1.4 Competition in small business banking

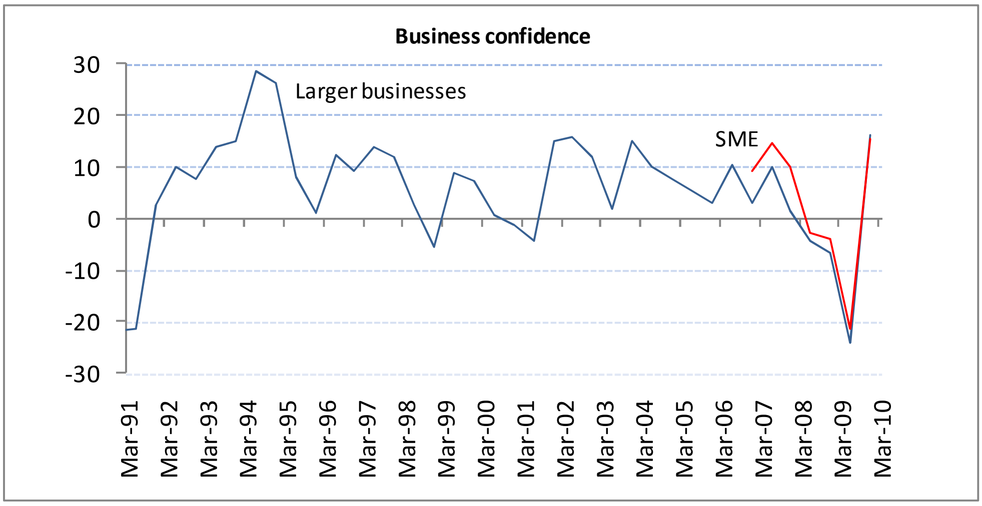
Throughout the global financial crisis, Australian banks continued to lend to small business. There is a wide variety of product and pricing options available.

Undoubtedly the global financial crisis has meant 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. It is still a contestable and contested market. In the last 12 months, for example, we have seen banks reducing and abolishing a range of fees, including some for small businesses, which they would not have done unless they were competing fiercely for customers.

2. Business confidence

High level indicators such as business confidence measures do not indicate that access to finance is a significant impediment to continuing economic recovery in the small business sector.

After reaching a low of *negative 26.3* in March 2009, business confidence for small and medium businesses has turned sharply positive. Depending on how closely correlated large and small business confidence is, it could be suggested that small business confidence is nearing, or is at, above average levels over a much longer timeframe than for which the small business data are available.



[1]

3. Answers to Committee's questions

Question 1

Can you give us any indication of the profitability percentages for small business lending, compared to lending to bigger business?

Answer

In broad terms, the contribution to bank profit from retail 'consumer' banking is in the order of 40%-45% with the majority of bank profits being generated from

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[1] NAB - Monthly business survey

business and institutional banking, funds management and other smaller activities (55%-60%).

Question 2

What proportion of the increase in banks' lending to small business would have come from an increased market share for banks, as opposed to the banks' sharing in an increase in total lending by the financial system?

Answer

There is no data available to ABA on business lending by non-bank lenders.

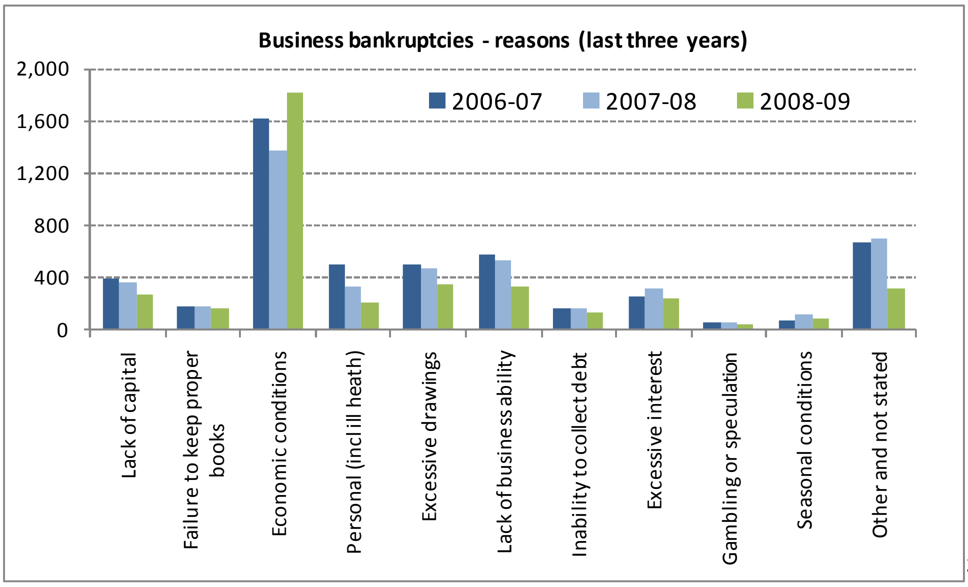
Question 3

In the Financial Review of 12 April 2010 it is reported that the Commonwealth Bank tipped 79 small businesses into administration, up 13 per cent from 2008, but the ANZ and NAB would not say how many they tipped into administration. Are those figures made publicly available in terms of the number of businesses that are either tipped into administration or individuals pushed into bankruptcy for failing to comply with their loan conditions?

Answer

There is no public data on individual cases.

Data from the Insolvency and Trustee Service Australia (ITSA – see chart following) indicates that 'Economic conditions' is the main reason for business bankruptcy and it was the only category that increased over 2008-09. The category 'excessive interest' fell by 23% in 2009. This, of course, is consistent with RBA data which shows that while spreads are higher, the levels of interest rates are not.



[2]

[2] ITSA

Banks report that a significant factor in the relative success of small businesses during the global financial crisis was the financial management skills of business owners and managers. There were some for example who focussed too much on profit rather than cash flow and cost control. The Government has invested in recent years in improving the general level of financial literacy of the wider community. An enhanced level of support for stronger financial management skills in small business owners and managers would be beneficial, assisted by industry programs.

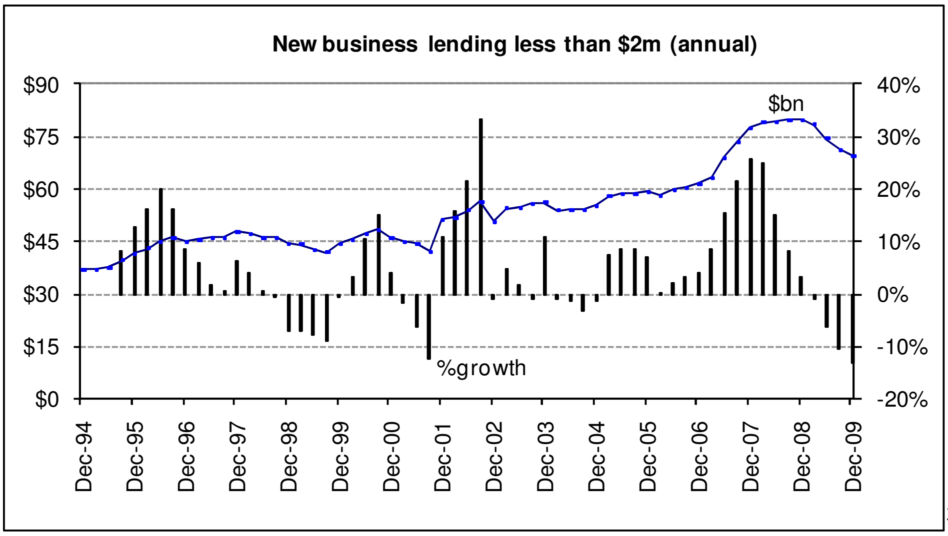
Question 4

Do you have any data, or partial information, on the extent to which lending by banks to small businesses has increased during 2010 so far?

Answer

The most recent data available from the RBA, which is the source the ABA relied on in the submission, is for the December 2009 quarter. Data for the March 2010 quarter is not yet available.

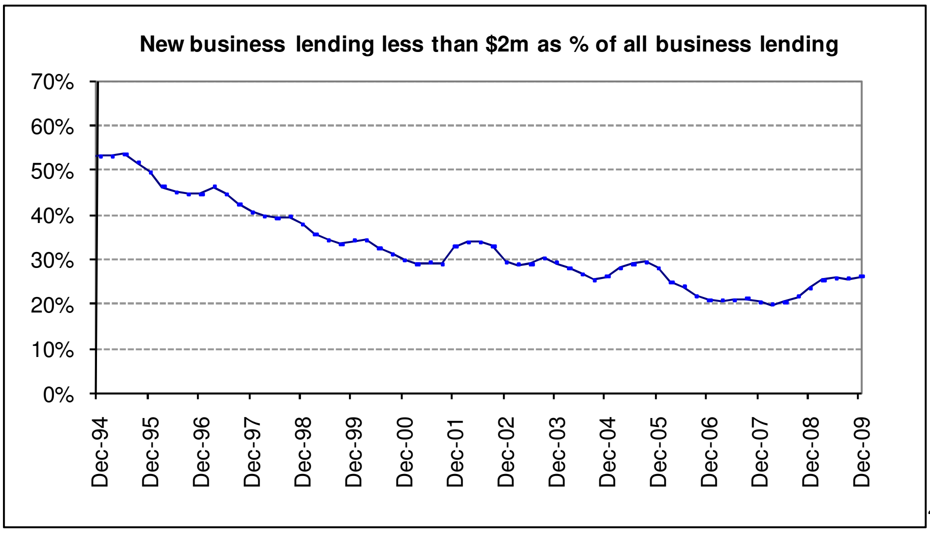
Over 2009, a total of $69.6 billion in new lending commitments, for loans of value $2 million or less, was made by banks to business. This was a fall of 12.9% over the past year. This compares with a 23.5% fall for loans where the value was $2 million or over.



[3]

[3] http://www.rba.gov.au/statistics/tables/index.html

After reaching a low of 19.9% contribution to new business lending in March 2008, this has now climbed to 26.2% (December 2009).



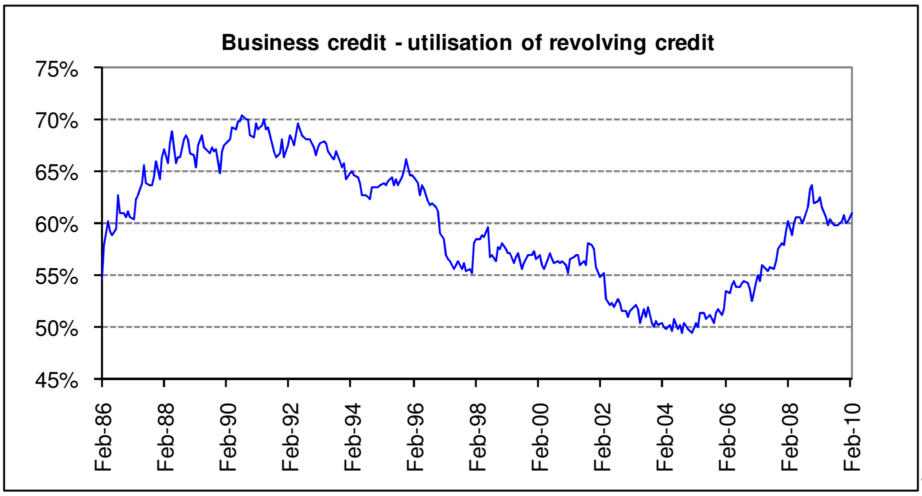
[4]

Question 5

Can you elaborate on the claim in your submission that "ABS data shows that the demand for new lending has been falling"? (page 3). Other than for usage of revolving credit facilities, does the ABS actually distinguish between demand- and supply-side explanations?

Answer

The data on use of revolving credit shows a drop-off in demand for this category of credit. As at the end of February 2010, businesses are utilizing 61% of their available credit limit.



[5]

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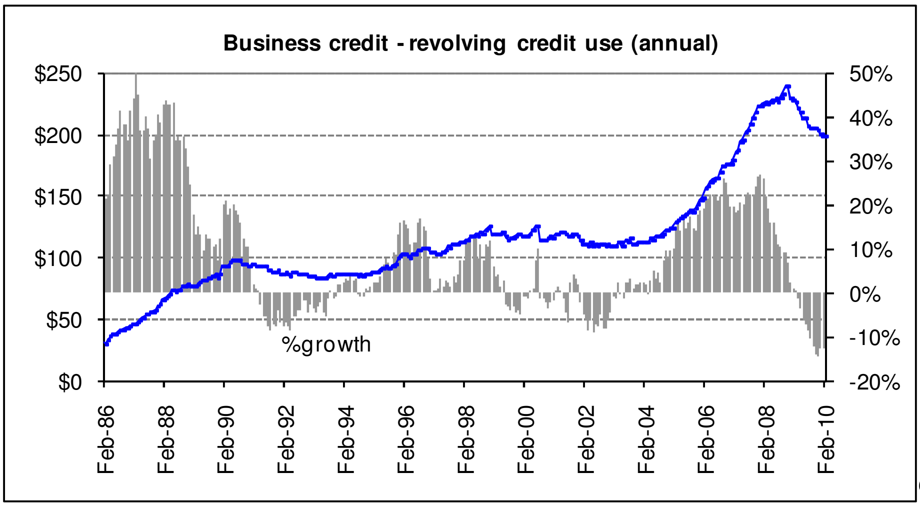
[4] Ibid

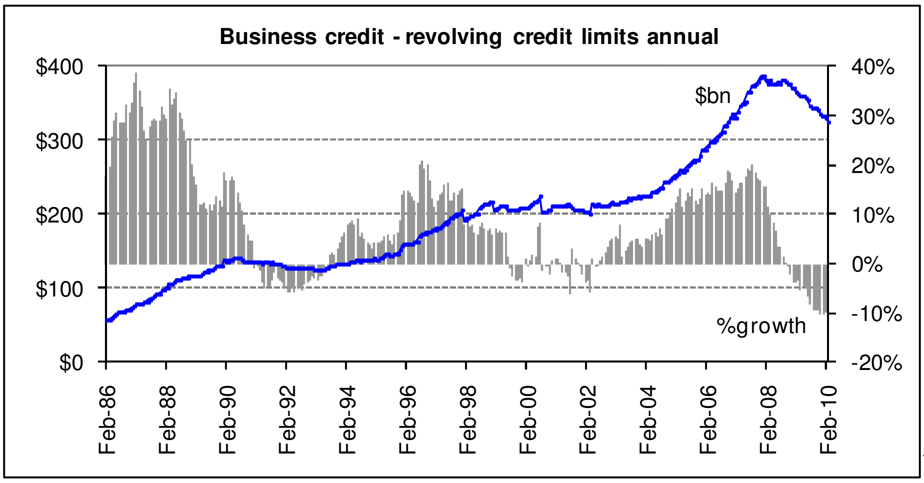
[5] http://abs.gov.au/ausstats/abs@.nsf/mf/5206.0/

After reaching a peak of $239 billion in October 2008, credit utilised by businesses is now (February 2010) at $198 billion, a fall of 13% over the past year.



[6]

Revolving credit limits for business were $325 billion as at the end of February 2010, a fall of 10.5% over the past year. This reached as high as $384 billion in November 2007.



[7]

The ABS national accounts produce a data series *gross mixed income* which can be used as a measure of aggregate business growth. It is the surplus or deficit accruing from production by *unincorporated* enterprises. It includes elements of both compensation of employees (returns on labour inputs) and operating surplus (returns on capital inputs).

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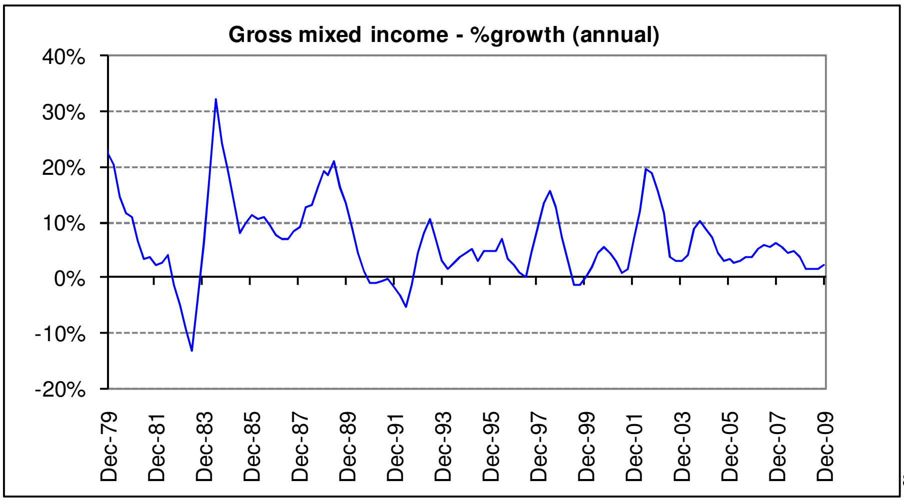
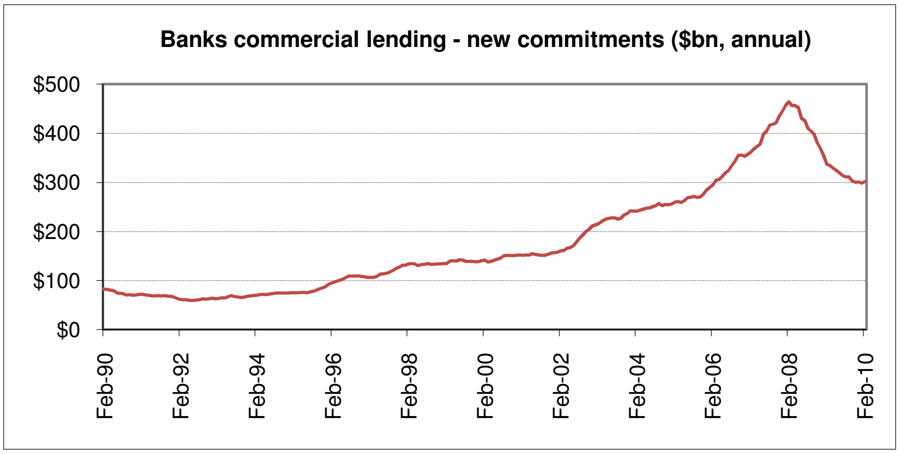
[6] Ibid
[7] Ibid

The following chart includes a large proportion of small businesses in the data series. At December 2007, the annual growth rate was 6.3% falling to 1.6% over the next 18 months (i.e. by June quarter 2009). It has now stabilised at a low level.



[8]

ABS data shows that the value of total commercial lending commitments was $301.5 billion over the 12 months to the end of February 2010. This has fallen from a record high of $459.0 billion reached over the 12 months to the end of February 2008.



[9]

The ABS data for commercial lending indicate that the trend for lending correlates with the economic indicator of gross mixed income. New lending commitments fell with the level of economic activity. ABA believes that to a significant degree, this is a demand effect. If business activity, investment and expansion decrease, then so does the demand for credit.

More generally, it can be seen in ABS data that (total) credit growth exhibits a strong correlation with GDP growth.

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[8] Ibid

[9] Ibid

Question 6

Do you think small business lending suffers when banks close branches in small towns? How important do you think the 'local knowledge' of a bank branch manager is in making a good loan decision for a small business?

Answer

Individual bank submissions to the Inquiry contain detail on these matters.

Question 7

Do banks assess risks of small businesses by considering the type of enterprise rather than examining the individual circumstances and record of particular enterprises?

Answer

Banks consider a range of factors when making a credit decision, which may include the "type of enterprise". Matters examined by the bank in the credit application process will include:

- Business history
- Industry information
- Ownership details
- Personal financial information
- Business financial information – historical and forecast
- Details on any sensitivity analysis and/or analysis of financial ratios

Banks are continuing to lend to viable small businesses, in all industry sectors.

Question 8

Your submission says that "the cash rate is not an accurate indicator of a bank's cost of funds" (page 4). Can you provide a more accurate estimate of the movements in banks' cost of funds over the period when the RBA was lowering and then increasing its cash rate? Have you seen the chart the RBA's Guy Debelle used in his recent talk which showed that since June 2007 business loan interest rates have increased relative to banks' funding costs?

Answer

There is no data available on the aggregate cost of funds for the industry. It would in case be a constantly fluctuating measure.

Historically, about 50% of banks' funding comes from deposits, a further 25% from short-term wholesale funding, and 25% from long-term wholesale funding. These proportions are now 53% deposits, 19% short-term wholesale funding and 29% long-term wholesale funding. Wholesale funding comes both from domestic and global financial markets. These proportions will vary from bank to bank.

Deposit growth has been strong over the last two years, with strong competition between banks for domestic deposits.

Short-term funding (excluding bills of exchange) comprises 73% domestic issuance and 27% offshore issuance. For long-term funding the split is 27% domestic issuance and 73% offshore issuance. These proportions vary between banks.

Spreads on short-term funding costs have been volatile since August 2007. On several occasions the 90-day Bank Bill Swap Rate (BBSW) spiked sharply (August 2007, September 2007, December 2007, February 2008, March 2008, June 2008, September 2008 and October 2008).

Long-term funding costs remain elevated, at approximately 100 basis points higher than prior to the global financial crisis. When banks have to replace or roll over their long-term funding, they are paying significantly more for these funds on capital markets, compared with before the global financial crisis.

For most of the last decade, banks' funding sources and the cost of funding has been relatively predictable. Movements in the Reserve Bank's cash rate have generally correlated with changes in total bank funding costs. Since the beginning of the global financial crisis, in late 2007, the cash rate has not been an accurate indicator of changes in bank funding costs. This has been confirmed by the Reserve Bank:

> *These changes in banks' cost of funds relative to the cash rate have meant that the relationship between bank lending rates and the cash rate has also become looser. It is difficult for banks to adjust their lending rates in line with changes in the cash rate when the cost of their funds is rising substantially relative to the cash rate.*[10]

The Reserve Bank also observed that:

> *We estimate that if banks had not adjusted their lending interest rates to reflect their higher cost of funds over the past couple of years, they would now be incurring losses.*[11]

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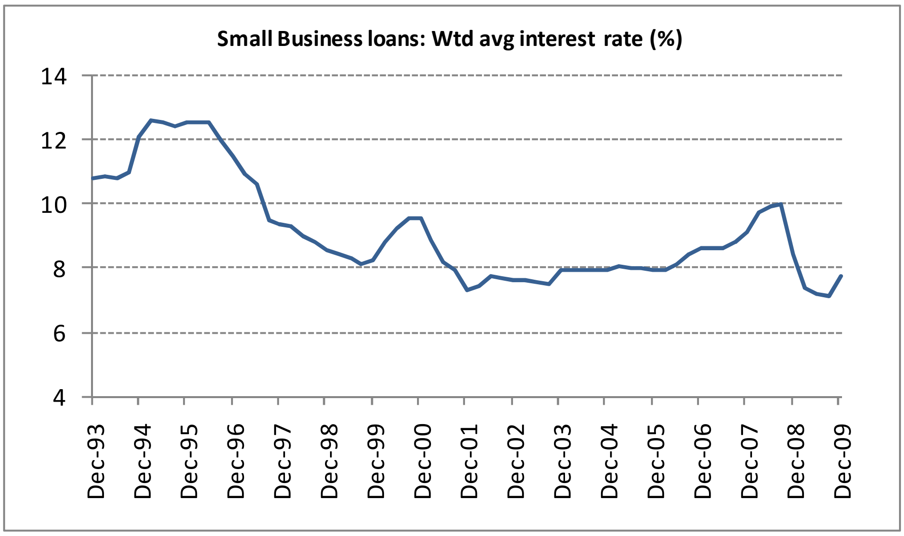
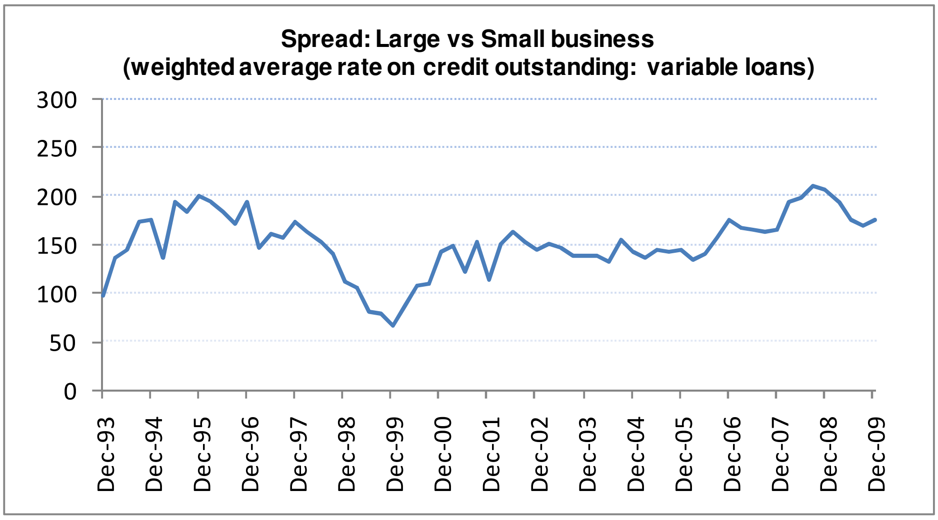
[10] http://www.rba.gov.au/publications/bulletin/2010/mar/pdf/bu-0310-11.pdf
[11] Ibid

Interest rate decisions are a matter for individual banks, but Reserve Bank data indicates that the *average* weighted average interest rate on small business loans throughout 2009 was the lowest on record (data goes back to 1993).



[12]

Over the two and a half years from March 2006 to September 2008, the spread between small business loans (<$2 million) and large business loans increased from 135 bps to 211 bps. Since September 2008, this spread has fallen to 175 bps.



[13]

Question 9

A chart in the March 2010 RBA Bulletin showed that the net interest margin for major banks is consistently higher than that for regional banks over the past decade, and the net interest margins for major banks have increased in the past year. Would it be reasonable to conclude that customers of regional banks – small business and others – are therefore worse off when regional banks are taken over by major banks? Does this increase in interest margins suggest overall

[12] http://www.rba.gov.au/statistics/tables/index.html
[13] Ibid

competition has declined in the banking market? Is there any reason to think there is greater competition for small business lending than other areas?

Answer

Comparisons are difficult, but an analysis simply based on net interest margin does not take into account the price, value and service quality mix that customers enjoy. Net interest margin has widened – due to repricing of risk.

Undoubtedly, the global financial crisis has meant that there is less choice. We know that there are some players that have left the market. 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, particularly unpopular fees, which they would never have done unless they were competing fiercely for customers. There has also been very strong competition for deposits.

The following is reproduced from the ABA submission (pp 12-13):

> 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[14]) 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.*[15]
>
> …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…[16]

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[14] http://www.canstar.com.au/

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

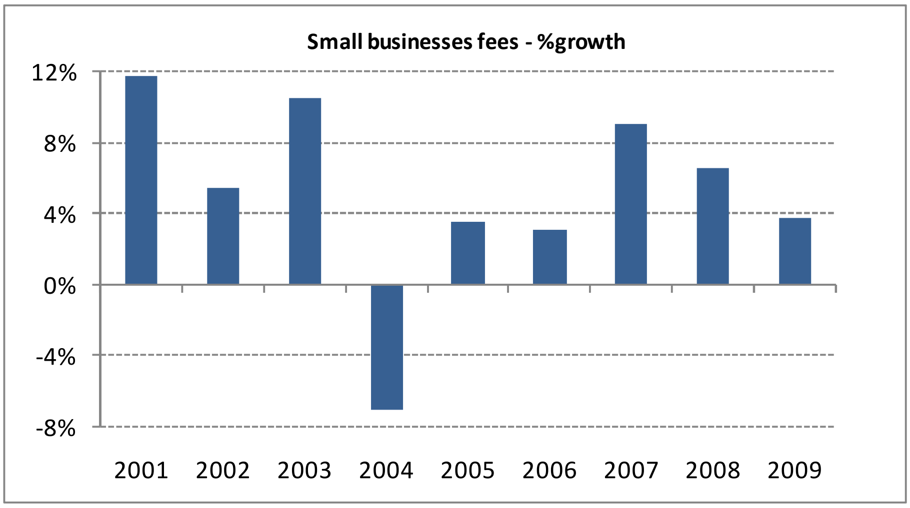
[16] RBA submission to Inquiry, p.6

Question 10

Can you elaborate on the claim in your submission that "There have been significant downward movements in bank fees for small business and other customers over the last 12 to 18 months" (page 6), given that the Reserve Bank's submission describes increasing, indeed accelerating, bank fees for small business?

Answer

Initial data for 2009 suggests that the growth in bank fees from small businesses was low, below 4%. Growth rates have fallen significantly over the past two years, in particular, over the period of the global financial crisis.



[17]

Question 11

Banks have recently increased fees on overdraft facilities and attributed them to being required to put aside capital for unused lines of credit. Can you explain the calculation of how much these new capital requirements add to the cost of a $100,000 overdraft?

Answer

This is matter for individual banks. Calculation methods would vary.

Question 12

Can you elaborate on the statement in your submission that "Capital required by 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" (page 8)? Has this changed recently? How does this compare to the relative default rates on small business loans and home loans?

Answer

See for example, APRA's Prudential Standard APS 113 - Capital Adequacy: Internal Ratings-based Approach to Credit Risk[18].

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[17] RBA Bank Fees Survey. The 2009 number is an estimate

Banks are obliged to risk-weight their assets, including business loans and classes of business loans. The risk-weighting takes into account key measures including:

- exposure at default (EAD) - the gross exposure under a facility (i.e. the amount that is legally owed to the ADI) upon default of an obligor;
- loss given default (LGD) - the Authorised Deposit-Taking Institution's (ADI) economic loss upon the default of an obligor; and
- probability of default (PD) - the risk of obligor default.

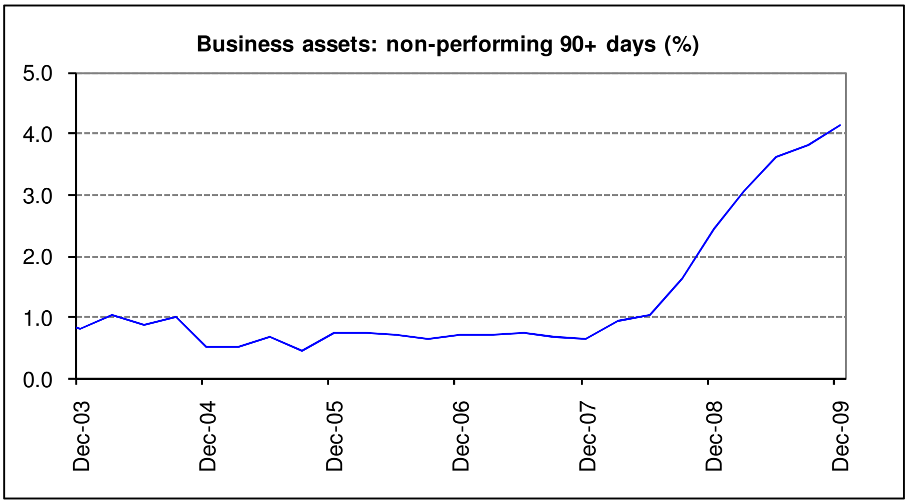
The calculations are complex, but in general terms, the higher the risk-weighting, the greater the amount of capital the ADI has to hold against those risk-weighted assets.

APS 113 also provides for specific risk weights for specialised lending such as project finance.

> *An IRB approval may provide that the FIRB or AIRB approach applies to an ADI's corporate IRB asset class except in relation to one or more of the specialised lending (SL) sub-asset classes detailed in paragraph 41 of this Prudential Standard. In that event, specific risk-weights associated with slotting categories must be used (refer to Attachment B) for the purpose of deriving regulatory capital for UL for the relevant exposures*

RBA data (see chart following) shows that 90+ days arrears for business loans, a key indicator of credit risk, remain at elevated levels: 4.15% at the end of 2009. Only two years ago, this was 0.66%.

The 90+ days arrears figure for home loans is holding at approximately 0.6%. Two years ago it was 0.4%.



[19]

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[18] http://www.apra.gov.au/ADI/upload/Final-APS-113-November-2007.pdf

[19] http://www.rba.gov.au/statistics/tables/index.html

Question 13

What role do you see banks playing as financial advisors to small business?

Answer

Banks play an important role, ranging from detailed financial planning to advice on specific products and services. Advice provided conforms with disclosure and other legal obligations.

Bank web sites provide a great deal of detail on their advisory services.

Question 14

Do banks have an obligation (legal, prudential or moral) to ensure that a small business will benefit from a loan and can afford to repay it from future cash flows? Or is it enough to ensure that the loan is adequately secured against the assets of a small business owner, such that the bank will get their money back even if the business fails?

Answer

The key points are:

- ADIs are highly regulated and are required to meet prudential and legal obligations;
- Banks take a prudent approach to credit risk management; and
- Our banks risk management practices have been widely recognised in the performance of the industry relative to other banking systems globally.

Detail

Under the Banking Act 1959 the Australian Prudential Regulation Authority (APRA) has power to determine standards applicable to banks in relation to "prudential matters".

The Banking Act defines "prudential matters" matters relating to:

> (a) the conduct by an ADI, an authorised NOHC, a relevant group of bodies corporate, or a particular member or members of such a group, of any part of its or their affairs in such a way as:
>
> > (i) to keep the ADI, NOHC, group or member or members of the group in a sound financial position; or
> >
> > (ii) not to cause or promote instability in the Australian financial system; or
> >
> > (iii) not to cause or promote instability in the New Zealand financial system; or
>
> (b) the conduct by an ADI, an authorised NOHC, a relevant group of bodies corporate, or a particular member or members of such a group, of its or their affairs with integrity, prudence and professional skill.

APRA is empowered to publish prudential standards that are binding on banks. Relevantly Prudential Standard APS 220[20] on Credit Risk is a significant legal and prudential obligation on banks.

In summary the objectives and requirements of APS 220 are as follows:

(1) To ensure that all authorised deposit-taking institutions control credit risk by adopting prudent credit risk management policies and procedures.

(2) These policies and procedures must apply, in particular, to the recognition, measurement and reporting of, and provisioning for, impaired facilities.

(3) The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- have an effective credit risk management system that is appropriate to its needs;
- regularly review its credit risk management systems, taking account of changing operating circumstances, activities and risks;
- have a robust system for the prompt identification, monitoring, and accurate and complete measurement of its credit risk. This includes recognition and reporting of impaired facilities and estimated future losses on the credit portfolio; and
- maintain provisions and reserves adequate to absorb existing and estimated future credit losses in its business given the facts and circumstances applicable at the time. This includes maintaining a prudent level of a General Reserve for Credit Losses.

This Prudential Standard forms part of a comprehensive set of prudential standards that deal with an authorised deposit-taking institution's credit quality at Level 1 and Level 2.

It follows that there are significant legal and prudential obligations imposed on banks as authorised deposit taking institutions to ensure all loans to, in particular, small businesses are sound from a credit risk perspective.

Reliance by a bank on its security for financial accommodation provided to a small business over the assets of the small business or those of the small business owner without regard to the cash flow of the business to service the facility is considered to be not consistent with prudential principles and standards.

Prudential considerations require that a bank ensures that its risk of loss given default is appropriately managed and minimised but this is not to say that a lending commitment is compliant simply because it is adequately secured. A business' cash flow is central to credit quality as it is to a bank's profitability.

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[20] http://www.apra.gov.au/ADI/upload/Final-APS-220-November-2007.pdf

Banks are businesses that seek to generate profits for their shareholders in providing the critical economic function of financial intermediation, that is, sourcing funds from depositors and wholesale markets and assuming the risk of repayment of those funds when allocating those funds to the community, individuals and businesses, in the form of loans and other financial accommodation.

Question 15

What impact do you think the bank funding guarantees have had on lending to small business?

Answer

The guarantees, for which the banks paid more than a billion dollars in fees, supported market confidence and stability during a period of great uncertainty internationally, and facilitated the continuing provision of affordable credit by banks to their small business customers.

Question 16

What do you think of the Australian Industry Group's view that "There has been little incentive for businesses to improve their risk profile via better management, with the view that the banks only look at asset backing to determine the interest rate"?

Answer

We have seen no evidence which supports the AIG claim. Banks offer cash flow and unsecured lending products, as well as revolving credit facilities.

Question 17

What are the main impediments to small businesses switching banks?

Answer

There are no substantial barriers to switching bank accounts in Australia. Many small business customers already have multiple accounts with different banks.

It is true that when changing transaction accounts to a different financial institution, there is some paperwork to re-establish direct payments, but this is not a barrier.

Would bank account number portability help?

Answer

Whilst we can appreciate the appeal of such a concept, this will not be pursued by the wider industry at this stage given the very high cost, complexity and disruption involved in the potential implementation of such a facility.

By way of background, the account number (including the BSB component) is a unique (to each bank) identifier which permits all the bank's systems and customers' systems (e.g. payroll, accounting packages etc) to 'know' where to send funds. Financial institutions maintain separate IT systems for the different payment clearing systems and each IT system is integrated into many other product and accounting systems. Account portability would mean a fundamental change to each of the IT systems used to exchange payments and substantial rebuilding of other systems.

Moreover, many businesses and service providers, including government departments (such as ATO and Centrelink) have IT systems which store BSB and account number information for their staff (for payroll purposes) and customers. It would require them to also update their IT systems and payment records at considerable expense.

Are stamp duties a major impediment?

Answer

A move away from State taxes on business produces measurable efficiency benefits, since it improves exports and investment. Efficiency gains can be of a similar order to other significant microeconomic reforms of the past. While the improvement in exports may be reduced by adjustments in the exchange rate over the medium term, the improvement in investment quality is ongoing. The revenue impact could be redressed by taxes on relatively immobile tax bases available to the States and/or additional grants from the Commonwealth out of its increased revenues from the efficiency gains.

Removing State taxes on business, particularly stamp duties, including conveyance duty, would have significant efficiency benefits. The economic case for this change has been elaborated in a study by Access Economics that was provided to the Henry Review by the Financial Industry Council of Australia, of which the ABA is a member.

Question 18

A number of submissions have called for the establishment of a 'development bank' to lend to small business. What do you think of this idea?

Answer

There is no compelling case. If the objective is to create greater competition in banking by setting up a major player in banking that is government owned, then the result would be to disproportionally affect small financial institutions, which will erode competition.

There have been a number of major problems with government owned banks in Australia recent history, which have required significant investments of taxpayer funds.

We have a very good banking system in Australia, which survived and continued to support its customers during the most serious "stress test" since the Great Depression – the global financial crisis – and structural change of the nature suggested has no clear benefit.

Question 19

What is your view of the NSW Business Chamber's suggestion of a temporary, appropriately priced, guarantee of 80 per cent of the value of business loans below a certain size?

Answer

The detail of the Chamber's proposal and how it would operate is unclear, but on its face, the change would be distortive. What the financial system needs now is certainty and clarity, particularly as we approach the implementation of major global regulatory reforms.