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"Banks, Business Lending & The Economy"

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Ladies and Gentlemen, everyone knows small to medium businesses (SMEs) provide the backbone to our economy, but here are some very quick statistics that may surprise you. In 2008, there were approximately 500,000 SME's employing between 1-200 employees.

SME's employ 7 out of 10 Australians – or 7.3 million people.[1]. That term so often used to describe SMEs, the engine room of the economy, is not a throw-away line. It's an economic reality.

For some of these businesses, equity will provide some or all of their capital requirements. But many will require debt to finance growth.

So how the banks approach the financing of this sector is critically important – not only for the SMEs, and their owners and employees, but for their customers, their suppliers, indeed, the Australian economy. And, I should hardly need to add that a strong SME sector is good for banks as well.

NAB is the acknowledged industry leader in business lending – especially to the SME sector. In Australia, NAB has total outstanding loans of over $100 billion, approximately 30% of all lending to the SME sector. Something we are very proud of.

By the end of 2009 our lending book to SMEs had grown by $5 billion – in an environment where the majority of our competitors had gone backwards. And NABs lending to SMEs has grown by more than 100% since 2005.

APRA figures show that all the other banks, in aggregate, reduced business lending by $28bn in 2009.

We were proud to be the largest lender to SMEs during one of the toughest economic periods in our history.

I have said before, and still believe now, that how we worked with our customers during those tough times would be how we are remembered by our customers for many years to come. We had to walk the walk, not just talk the talk.

But if you read, listen and watch the media, you would have a different impression. What we hear constantly from SMEs is that access to bank lending has become an issue – a big issue.

So much so that there is now a Senate Committee inquiring into Small Business Finance matters – a development which is welcomed by the National Australia Bank.

I am hopeful this process will result in a better understanding of the many issues involved in SME lending for all industry participants. We look forward to engaging with the Committee as it proceeds with its inquiry.

The concerns expressed by SMEs resonate for a reason. What the evidence suggests is that bank lending in Australia, in terms of cost and availability, is skewed towards personal (particularly housing) and away from business. But the reasons why this is so are not well understood, and that's what I want to address today.

Good quality business lending is critical to a healthy economy. Doing this well, banks perform an important societal role in supporting investment, employment and wealth creation.

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[1] Figures refer to the non-finance private sector (i.e. excluding the government sector and the finance sector) using recently published ABS data for 2007/08.

I emphasise “good quality” lending because banks that lend carelessly inflict a big cost on their customers, shareholders and the broader economy. This is clearly illustrated by the Global Financial Crisis (GFC) especially in some overseas markets.

Australia’s strong banking system enabled credit to continue flowing even at the height of the GFC. Not at pre-GFC levels – where I would argue that some credit was too loose and we should not return to those lending practices – but certainly at a level that helped keep Australia out of recession when almost every developed country saw their economies contract.

So Australia, and I believe NAB in particular, was able to keep the credit wheels spinning. At NAB we also moved to abolish - not reduce; abolish - a number of fees within Business Banking. A move which delivered additional benefits to more than 500,000 business account holders, many of these small and medium businesses.

None of this means that there have not been some very tough times and experiences for many SME’s and their banking relationships over the past 18 months.

There is no doubt that many banks, including NAB, have had to have some very difficult conversations with some customers as they have repriced loans to reflect the increased risks in the economy.

A recent Price Waterhouse Coopers survey of private businesses indicated the extent of pain some customers have been through. More than 81% of businesses said difficulties in accessing credit could stop them meeting their targets during the next year.

I said earlier that while the Australian banking system has been a model of stability over 2008-09, it does contain, arguably, some distinctive characteristics which impact on business lending.

First, Australia has a low deposit to loan ratio – less than 50% of all lending is funded by domestic deposits - and thus a material reliance on offshore funding.

Second, a segment of the lending market (foreign banks, regional banks and non bank financial institutions (NBFI’s)) grew strongly in the decade up to 2009 reaching close to one third of the whole system. But in many cases these players were ill-equipped to manage the shocks that the financial system had to deal with in 2008-09 and they withdrew lending capacity from the Australian domestic market. This impacted business’ borrowing and SME’s in particular.

Third, Australia has in relative terms a high exposure to and potential lending bias towards the household sector. This concentration in household lending in Australia has some potentially important consequences for our financial system.

We have a high level of debt in the household sector now exceeding $1.1 trillion. This figure is higher than our GDP.

Since 1995 Australian bank household lending grew from ~$160 billion to $1.1 trillion today. The ratio of debt to disposable income of around 130% is amongst the highest in the developed world.

The balance sheet composition of the four major banks reflects this bias towards household lending, particularly at the large Sydney based banks which both have more than 60% of their total loans in household lending. By comparison NAB’s tilt toward business lending means less than 45% of our total loans are to households.

The vast majority of household lending in Australia (85%) is in residential mortgages, which has seen considerable growth in 2009 due to Government stimulus (first time homeowner grant), relatively low interest rates and a tax system which makes investment properties very attractive.

Another important influence is the international Basel II capital adequacy rules which took effect here in Australia in 2007/2008.

These rules implicitly encourage banks to favour residential mortgage lending over business lending as residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks. To address this problem requires a continuous focus on developing the most capital efficient product solutions for business lending.

This means that banks can do up to five times more mortgage lending relative to business lending in terms of capital management.

Little wonder one former bank CEO recently quipped that Australian banks have become more like "building societies".

I think that one of the little focused on but absolutely critical questions for our industry and Australia's policy makers is the extent to which the Basel II capital rules create an economically unhealthy bias towards residential lending and distort capital allocation away from more entrepreneurial and productive sectors of the economy?

I think we need to consider what the long term effects of this are and how it might impact Australia's longer term economic progress and growth.

Also, if there is a concerted effort to reduce reliance on wholesale funding and increase the stable funding index by Australian banks, then one possible consequence is that bank balance sheets will start shrinking. This is an issue as the link between debt and economic growth is well established. According to one expert[2], the global economy probably needs around $4 to $5 of debt to create $1 of GDP growth.

Financing the productive capacity of the economy is critical to long-term success. A banking system that is not geared towards doing this may be constraining the economy, despite headline economic figures spurred by the resources sector and the concentration risk on China.

The extent to which this is happening may reveal a cost in the future and should not be ignored.

There is a much bigger long term debate to be had here because a banking system which allocates capital away from the most productive areas of the economy – business – is ultimately bad for growth, bad for competition, bad for jobs, bad for business and in the end bad for Australia.

This is the really big banking debate Australia needs to have, but for the moment I need to return to the more immediate issue.

There is little doubt that some banks stood back from the business market in 2009. Some of these banks are now returning given that economic uncertainty is less of an issue and this is a good thing.

But in the years leading up to the GFC, we saw the emergence of a strong regional bank and "shadow banking" or near banking system, which provided ~20% of lending to SMEs, influenced by growth in the financing broker market. This segment of the market will take longer to recover and thus there is a gap created here which may be causing some of the angst being voiced by SMEs.

[2] *GFC Cures – Placebo Effects*, Satyajit Das, 2009. See also Collateral Damage: Preparing for a Two-Speed World, Boston Consulting Group, 2010

For larger firms there are many choices open to them from equity raising, various debt capital markets and the banks. For SME's it is largely the banks and near banks. Those SME's that are encouraged to go for a public listing of their equity, often find that this can be an expensive and underwhelming experience, with many suffering from the triple 'U' virus – unloved, unwanted and undervalued, resulting in their equity value languishing and creating a sense of wealth destruction and frustration.

Very small businesses often find themselves in a particularly vulnerable position, which warrants special consideration. Banks often struggle to provide credit to businesses with a limited track record and little in the way of tangible security, such as a residential home. At the same time, entrepreneurs are understandably reluctant to put at risk their home in pursuit of a new business idea. The idea of venture capital can be even more unappealing for many entrepreneurs.

So I think that some businesses have legitimate complaints about how their banks either enforced onerous refinancing terms or simply refused to entertain new lending propositions.

One of the charges often levied at banks is that they have changed their risk policies and settings, making access to credit more difficult to obtain. Yet the majority of banks, including NAB, claim they have not changed their risk settings, except perhaps in very limited cases for sectors such as commercial real estate. If this is the case, then why do small businesses feel like the credit tap has been turned off?

At NAB we have been very conscious of how the rhetoric of senior management can influence the behaviours of bankers. Whilst risk settings may not formally change, messages from senior managers can impact confidence, often unintentionally, making bankers err on the side of caution (sometimes extreme caution). As a result, aspects of risk analysis which may have been interpreted as neutral to positive in a strong economy, may be interpreted in a negative way in a weak economy. For this reason, banks need to be very clear on their risk settings and ensure bankers understand them and are well equipped to effectively communicate them to customers.

There is an argument being pushed by some people in and around our industry that some business customers have been charged higher interest rates so that banks can subsidise the lower rates they charge to personal customers.

I can assure you that at least as far as the NAB is concerned this argument is false, uninformed and ignores three important facts that everyone familiar with contemporary business banking would know.

Firstly, as I have already noted, as a result of Basel II, the capital requirements for business lending are far more onerous than they are for mortgages – so it is just simply more costly for banks to lend to businesses than to personal customers. Fact.

Second, this means that on an industry basis, the return on equity that banks are making on residential mortgages is substantially higher than on business loans and over double the industry cost of capital. Fact.

And finally, the reason business customers are often required to pay higher interest rates, is because the risks and potential for default are much higher. The $13 billion in bad and doubtful debt charges that the banks reported in 2009 was largely from their business lending activities. Fact.

The reason banks have not passed on as much of the interest rate decreases during 2008/09 to business customers as they did to personal customers was because both the cost to lend to business under Basel II and the risks in the business environment increased significantly.

Until the GFC, Australia had enjoyed a fairly benign risk environment since the early 1990's. As the RBA recently noted, net interest margins on the major bank's Australian operations narrowed by 170 bps between 1995 and 2007.

But it is now apparent to everyone that the financial system was underpricing risk during the years leading up to the GFC and throughout late 2008 and 2009, we saw a systematic increase in risk margins for businesses.

This was a necessary correction as much of bank lending found itself obviously underpriced and poorly structured for risk coming into the GFC. So, whilst competition drove margins down, the crisis has shown that some banks and non-bank financial institutions were competing in ways that were not sustainable.

Their customers soon discovered that easy credit provided in a bull market can be brutally withdrawn in a bear market.

Lending money is something that takes little skill beyond good sales techniques. Lending money responsibly requires good risk management skills which contemplate volatile markets, economic cycles and an understanding of the price for risk. This requires a different set of skills.

The cost of debt will always be contentious. However, as the GFC unfolded I believe NAB stood by our customers, found credit for new customers, and took a responsible approach to the cost of that debt. But business banking, especially business banking for SMEs, is about more than credit and how much it costs. It's about servicing the customers in all aspects of that word.

At NAB, we have a commitment to have more business bankers in more places, with over 5000 staff of which approximately 60% are actively involved in working directly with our customers.

We are continuing to recruit more business bankers. In the past 12 months, we have recruited more than 150 new business bankers to take care of our customers, and we plan to recruit another 200 in 2010.

And we're also opening more Business Banking Centres.

Customer relationships are managed locally at business banking centres by dedicated business bankers who are supported by local credit partners and specialists. We call this the "church tower principle" to business banking i.e doing business with customers you can see from the local church spire; in other words, community based banking. Real relationship banking.

Our goal is to have our small and emerging business customers, as satisfied as our SME customers, where NAB is the market leader in customer satisfaction.

Conclusions:
Ladies and Gentlemen, I have covered a lot of ground today and would like to leave you with four key messages:

1. Providing SMEs with access to credit is pivotal to a healthy economy. And a banking system which does this well plays an important economic and societal role.
2. Banking is a highly valuable service, which is conceptually very straightforward, but in practice it is complex. The consequence of poorly managed banks is so obvious to us today as we look around the world.
3. Time will tell if our banking system's increasing bias towards household lending is ultimately best serving Australia's long term economic interests. This is an issue for individual banks and for our regulators.

4. Finally, we can't ignore the reality that businesses do not feel as well served by our banking system as they should. At NAB, we are proud to have loaned more than $100 billion to SMEs, but we are also very conscious of and concerned by any sense that credit is not readily available to support good businesses.

Thank You.