NSW Business Chamber

7 May 2010

Mr John Hawkins
Secretary
Senate Economics References Committee
Parliament House
CANBERRA ACT 2600

RE: Small Business Access to Finance Questions on Notice

Thank you for providing the NSW Business Chamber with the opportunity to appear before the Senate Economics References Committee as witnesses in the small business access to finance hearing on 12 April.

Over the course of the hearing, we took several questions on notice, and committed to provide the Senators with responses to these questions in a timely fashion. This letter also sets out responses to the questions raised in your email to Micah Green on 24 April. Our responses to these matters have been set out below.

Q1/ Do you have the final results from the survey to which you referred at the hearing?

The NSW Business Chamber's Business Conditions Survey for April 2010 was released on 27 April. The survey found that business anticipates increased sales, exports, profits, capacity utilisation and employment over the next quarter, but at the same time, business reports that actual business conditions, revenue, sales and employment data are below levels reported at the end of 2009.

Access to finance remains a significant issue for members. 24.3 per cent of businesses reported a decrease in the ease of access to finance (up from 20.5 per cent in November 2009), and 42.5 per cent reported an increase in their costs of finance (up from 34.2 per cent in November 2009).

A copy of the survey has also been attached for your information.

Q2/ You mentioned that in Canada the charge for the small business loan guarantee could be as much as 300 basis points. How would you envisage the price being set in a scheme here?

There is a significant difference between the margin being charged for the guarantee in Canada and the margin being charged in the UK. While the fee in Canada can be as high as 300 basis points, the fee in the UK has ranged from 150 to 200 basis points.

The purpose of the fee is two-fold. Firstly, it recognises that the provision of a Government guarantee shifts some risks onto the Government's balance sheet, and provides the Government with appropriate compensation. Secondly, the use of a price signal ensures that small businesses and financial institutions will only seek to use the guarantee where necessary.

The fee should be set at a level which means that the overall scheme is broadly revenue neutral for the Government. That is, the revenue raised by the scheme should be roughly equal to the value of guarantees called upon by the banks. Calculating the appropriate fee level will depend on the overall risk profile of small businesses using the guarantee and their overall probability of default.

Such a calculation should be made by the Government, in consultation with relevant stakeholders (such as the banks and APRA), if additional data is required. The Government already has some expertise in pricing Government guarantees, having done so in the case of wholesale lending and State and Territory borrowing.

Q3/ Could you have a look in the Hansard at the statements of APRA, the Reserve Bank and the ABA in relation to how they have characterised the state of competition in the banking market and offer your comments?

The RBA notes that overall, lending to small business has remained largely steady over the course of 2009, following more than a decade of consistent growth. It was generally acknowledged by most respondents that the change in lending levels was at least in part due to supply factors.

Different banks have responded differently to the global financial crisis and its aftermath in their treatment of small businesses. The Commonwealth Bank increased the overall size of its small business loan portfolio by 8.6 per cent between July 2008 and December 2009. On the other hand, Westpac's business loans fell over the course of 2009.

There has been a significant reduction in the number of players in the market, with many small providers and foreign banks closing their operations. In this environment, an increase in lending levels by those who remain may not be sufficient to maintain overall lending levels in aggregate.

In addition, those financial institutions left in the market, and particularly the larger banks, were generally targeting a lower-risk sector of small business loans. This difference in risk appetite has meant that in many cases, no one has stepped in to fill the gap left by small lenders.

In looking at interest rate spreads as a measure of competition, we recognise that there is a difference in risk profile between an owner-occupied home loan and a residentially secured business loan. Bank data on loan default rates indicates that small businesses are more likely to default than home-owners, and that this additional risk premium results in increased margins on small business loans despite identical levels of security.

However, while the magnitude of this risk premium should be fairly consistent between the banks, their pricing of this premium varies considerably. The Commonwealth Bank has assessed that an appropriate spread between their home-loan and small business loan lending rates is 50 basis points. On the other hand, for many other banks the spread between the two products is well over 100 basis points. It is difficult to reconcile how different banks could price the same risk so differently, and would suggest that some banks are using the current market conditions to push up margins on small business loans further than may have been possible in a healthily competitive market.

Q4/ 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?

Local bank branches can play a role in providing small businesses with a local business manager who understands their business and makes loan decisions based on the particular circumstances of that business. However, regional manager models adopted by some banks also provide small businesses with the same quality of individual service, without the need for a local bank branch.

What is most important to small businesses is that the decision making is decentralised and personalised, not the actual physical presence of a bank branch. A very small local branch is of little use to a small business if lending decisions are made in head office and the local staff lack the authority to customise their arrangements to meet the particular needs of the small business.

Q5/ 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 cashflows? 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?

Consideration of both cash flows and security is in the best interests of both the banks and their small business customers. The failure of a small business is bad for the business, but is also bad for the bank given the costs associated with recovery of outstanding debts.

In assessing loans, the primary consideration of the bank should be the capacity of the small business to repay the loan through ongoing business revenue. Banks which only consider security in assessing small business loan applications are not acting in the best interests of their shareholders or their small business customers.

Q6/ Do you agree with 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"?

We would agree that there is a perception that, in the current market, banks are only looking at asset backing. While banks may not be exclusively considering security when making loan assessments, it does appear that the pendulum has swung too far in this direction, with banks now placing excessive reliance on this element in assessing loan applications.

For banks seeking a stable long-term customer base, greater priority should be given to the capacity of borrowers to repay their loans, as small businesses that go out of business are not going to be long-term customers.

Q7/ Your submission refers to the desirability of making it easier for small businesses to switch banks. What are the main impediments? Would bank account number portability help? Are stamp duties a major impediment?

Anecdotal evidence from our members suggests that banks are currently less interested in winning additional business from small business customers. Some members have stated that banks are worried that businesses trying to leave their current provider must be doing so because they represent a bad risk.

There is also a perception amongst small businesses that there is not much benefit from trying to shop around, as the banks all have similar application and assessment processes. It would be interesting to see if banks are willing to provide data on the levels of switching into and out of their institutions before and after the GFC. This would help to provide some insight into the impact of competition on the ability of small business customers to change providers.

While we accept that entry and exit fees are necessary for banks to recover the costs of establishing or closing a loans, it is important that they are set appropriately at cost recovery levels and not overinflated by banks and used as a tool to generate additional profits.

Stamp duties may or may not be payable where a small business chooses to refinance their loan with a different financial institution. The applicability or otherwise of the stamp duty would be dependent on the particular tax laws in each State jurisdiction. However, at a broader level, we would note that nuisance taxes of this kind are both an impediment to efficient market behaviour and an inefficient way of raising revenue. The recently released Henry Review also recommends the rationalisation of taxes such as these.[1]

Q8/ Your submission refers to the Government drawing attention to small business lending conditions. Do you have in mind a "MyBank" like the "MySchool" website?

NSW Business Chamber does not see a Government provided "MyBank" site as an effective way of drawing greater attention to differences in lending rates. Such products are already provided by the private sector (for example, Canstar Cannex – see www.canstar.com.au). Rather than duplicate existing services, there may be benefit in providing links to these websites through existing Government portals (such as www.business.gov.au).

We also believe that Government Ministers themselves, and in particular the Treasurer, can play a greater role in drawing attention to this issue when making public statements. Currently, the Government places greater public pressure on home loan interest rates than

[1] Australia's Future Tax System Review, Recommendation 81, p. 479.

it does small business interest rates. NSW Business Chamber believes that this disparity in focus is at least in part responsible for the difference in spreads between small business loans and home mortgage rates.

For example, when Westpac increased its home mortgage rates by 20 basis points more than the RBA last December, the Treasurer was quick to name and shame, referring to the move as “cynical” and “a slap in the face” for customers. Similar commentary around unjustified movements in small business interest rates would be welcomed.

Industry associations can also play a role in promoting interest rate information to their members. In this regard, the NSW Business Chamber has been analysing small business interest rate movements by the major and second tier banks, with a view to promoting this information in the future.

Q9/ 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?

NSW Business Chamber has noted calls for the re-establishment of a “development bank.” While recognising the role that a development bank could play in helping to improve competition in the banking sector, we reiterate our belief that a temporary Government guarantee of small business loans is a more appropriate policy response.

There are several reasons for this position:

- A guarantee of small business loans can be implemented more quickly than a development bank can be established. Access to finance is a significant issue for small businesses now, and a solution to this problem needs to be implemented in a timely fashion.
- The problem of access to finance is a temporary one. In the medium to long-term, it is expected that competition will return to the banking sector, and the pressures currently faced by small businesses in accessing finance will be alleviated. The creation of a development bank represents a permanent solution to what is not expected to be long-term problem. A small business guarantee would naturally phase out as competitive pressures returned to the market.
- A development bank shifts loan decisions from the private sector to the development bank, whereas a guarantee would leave banks responsible for assessing loans. Unlike the guarantee, a development bank is not a market based solution, and may result in funds being rationed to particular sectors of Government interest rather than the most deserving small businesses.
- The Government would also have to raise additional capital to finance the loans of a development bank. This is not necessary in the case of a small business loan guarantee.

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Other matters

Small business financial literacy

NSW Business Chamber notes that one of the issues facing small businesses in accessing finance may be a lack of understanding about the range of financial products available. While most small businesses will be broadly aware of debt and equity, and the different roles these can play, financial tools and concepts such as venture capital, factoring, discounting and business angels are generally less well understood.

In this regard, we note the success of the Government's *Financial Literacy Foundation,* and the role that this organisation has played in raising consumer awareness about everyday financial literacy issues.

The Government may wish to consider development of similar informational products or web-based tools for small businesses, particularly focused on access to finance. Dissemination of this information could be promoted through existing Government channels and websites, complemented by promotion through industry association member networks.

Taxes on bank deposits

While not specifically raised by the Senate Committee, we would also note that the recently released Henry Review recommended tax reductions on individuals' interest earnings on deposit products.[2] In addition to removing a current distortion in the tax system, such a change could also assist in reducing the cost of finance for small business customers.

This is because providing bank deposits with concessional tax treatment is likely to increase their attractiveness, leading to greater use by individuals. This would be expected to reduce banks' overall cost of funds as they can place greater reliance on deposits for their funding base. In turn, this is likely to reduce the margins that banks need to charge on their loans.

For this reason, NSW Business Chamber recommends that the Government provide a tax concession for bank deposits, along the lines of the model put forward in the Henry Review.

Should you require further information or clarification on any of these matters, then please do not hesitate to contact Mr Micah Green, Policy Adviser Tax & Competitiveness on 02 9458 7259 or via e-mail at micah.green@nswbc.com.au.

Yours sincerely,

Paul Orton
Director, Policy and Advocacy

[2] Australia's Future Tax System Review, Recommendation 14, p. 70.