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John F. Laker AO
CHAIRMAN

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Committee Secretary
Parliamentary Joint Committee on Corporations
and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir,

ACCESS FOR SMALL AND MEDIUM BUSINESS TO FINANCE

This letter has been written to assist the Committee in its inquiry into access for small and medium business to finance.

Many of the issues of interest to the Committee were well traversed in the submission of the Reserve Bank of Australia (RBA), dated 24 March 2010, to the Senate Economics References Committee in its inquiry into access of small business to finance. APRA provided the RBA with data for and comments on this submission and had little to add in a separate submission. The RBA is updating the submission for this Committee.

APRA's comments in this letter are limited to the impact of prudential requirements on lending costs and practices, as per item (4) in the terms of reference.

APRA's prudential requirements applying to the provision of credit by authorised deposit-taking institutions (ADIs) distinguish between broad categories of credit (such as personal, residential mortgage and business); within the business lending category, however, the requirements generally do not distinguish between size of borrower. APRA's ongoing supervisory oversight of ADIs also does not generally distinguish by size of business borrower. As a risk-based supervisor, APRA's focus is on ensuring that ADIs are adequately capitalised for *any* of the types of lending activities they undertake and that they have appropriate risk management systems. That is, ADIs must have robust procedures in place to assess the ability of *any* borrower to service the loans (i.e. meet principal and interest payments) and, where there is security provided, this must be adequate and correctly valued. APRA also expects ADIs to reflect the credit risks to which they are exposed in setting their lending rates, with a higher risk margin on higher risk loans to reflect the greater probability of default and/or the potential for loss if the loans were to default.

APRA's capital requirements applying to the credit risk in business (and other) lending by ADIs are set out in what is known as the Basel II Framework, the global capital adequacy regime of the Basel Committee on Banking Supervision. This Framework, which was implemented in Australia from the beginning of 2008, allows ADIs a choice between two broad methodologies for calculating their capital requirements for credit risk.

Under the 'standardised approach', the credit risk-weight applied to unsecured lending to businesses without a credit rating – and the vast bulk of small and medium businesses do not have a rating – is 100 per cent. This is unchanged from the previous global capital adequacy regime (Basel I). As such, the introduction of Basel II would not in itself have had an impact on the provision or cost of unsecured finance to small and medium businesses by ADIs on the standardised approach. Exceptions to this requirement apply when:

- the loan is secured by a residential mortgage (see below);
- the business has a credit rating, in which case a lower risk-weight might apply; or
- the loan is in arrears or impaired and only limited provisions for loss have been raised, in which case a higher risk-weight is applied.

Many small business loans are secured against residential property. In such cases, the credit risk-weight under the standardised approach is the same as that applying to an owner-occupied mortgage; that is, there is no 'purpose test' to the loan in these circumstances. For example, the risk-weight would be 35 per cent for a loan secured against a residential property with a loan-to-valuation ratio of less than 80 per cent (compared to a risk-weight of 50 per cent under Basel I).

Under the 'advanced approach', an ADI can use its own internal modelling, drawing on its actual historical loss experience in the various lending categories, to assist in quantifying, aggregating and managing its credit risks. As a consequence, the credit risk-weights applied to lending to business are more sensitive to the risks attached to this lending. The risk-weights may be above or below 100 per cent (but are generally below) depending on the specific characteristics of individual borrowers, such as servicing ability and security provided. A technical adjustment also applies that, other things being equal, will reduce the risk-weight for small and medium business lending. Only five ADIs – the major banks and Macquarie Bank – currently have APRA's approval to use the advanced approaches.

Under the advanced approach, small business loans secured by residential property would generally have a higher risk-weight than an owner-occupied mortgage, reflecting historical experience that small business loans are likely to have a higher probability of default. However, the risk-weight would still be lower than that which would apply if the small business borrower had not offered this security.

Overall, the capital requirements for business loans secured by residential property will be lower under Basel II than under Basel I, for both the standardised and advanced approaches. Other things being equal, the introduction of Basel II would have had a positive impact on the provision or cost of secured finance to small and medium businesses by ADIs.

Other things were not equal, of course. The Basel II Framework was implemented in Australia as the global financial crisis was unfolding and any Basel II impacts have been dominated by demand and supply factors. The global financial crisis led to a reduction in the demand for finance by small and medium business as they reassessed their growth plans and borrowing intentions, as well as in the supply of credit as ADIs tightened their lending standards in response to higher loan loss rates and uncertainties about the economic outlook. These developments are discussed in more detail in the RBA submission.

APRA staff would be happy to appear before the Committee if that would be helpful.

Yours sincerely,